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The Fed Shifts Gears

THE impression had emerged during September of a Federal Reserve Board whose members were deeply divided over the need for further monetary tightening, as evidenced by the split 4-3 vote in favor of raising the discount rate to 11%. That impression was shattered only a little more than two weeks later by the Fed's dramatic announcement on October 6. Approved, unanimously, were bold initiatives to restrain growth of money and credit and, thereby, to break the expectations of accelerating inflation which were becoming so embedded in the economy.

Even with the benefit of hindsight, it is not yet possible to piece together a full explanation of this abrupt and radical shift in policy. But it seems clear that among the key elements behind the move were indications of a sharp upturn in economic activity at home, strong pressures from abroad for more aggressive actions to fight inflation, and increasing signs of speculative activity in the markets for precious metals and other commodities.

Figures released the day before the Fed's announcement showed a sharp rise in total employment in September and a decline for the month in the unemployment rate to 5.8%, down from August's 6.0% reading. That forceful indication that earlier recessionary tendencies were decidedly not cumulating may well have prompted both the Fed's staff and principals to conclude that the economy's underlying strength had been significantly underestimated. If that were the judgment, it was quickly validated by other impressive evidence. Retail sales figures, released in the week following the Fed's announcement, showed not only a 2.2% gain for September but also a sharp upward revision in the August numbers to a 3.1% in-

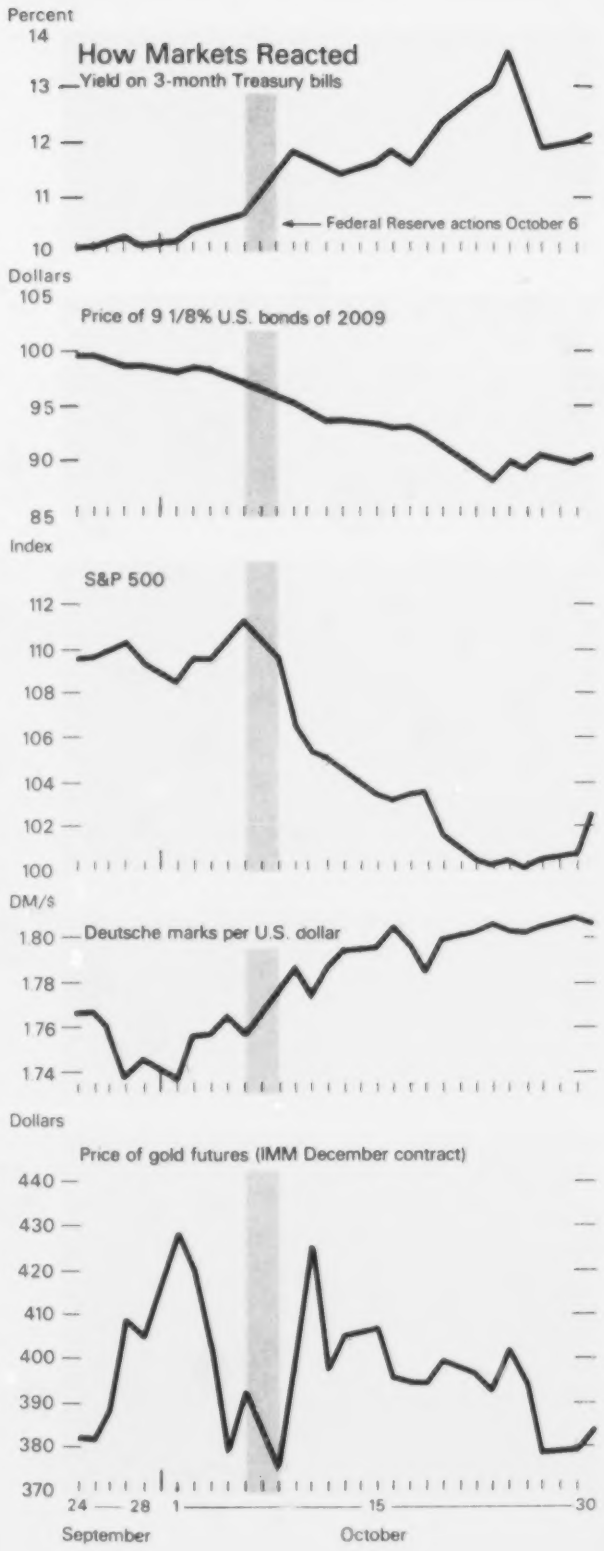
crease—producing an annual rate of increase for retail sales in the third quarter of 16%. Since then, September data for housing starts, personal income, durable goods, and leading indicators have all confirmed these impressions of greater-than-expected strength. At the same time, the nearly 14% rate of increase in the CPI reported for September emphasized the lack of any progress against inflation, while the $2.8-billion trade deficit for that month was a reminder of the international vulnerability of the dollar.

International pressures

Pressures on the Fed to alter its posture were by no means limited to developments in economic and financial markets. It is now reasonable to assume that when Federal Reserve Board Chairman Volcker and Treasury Secretary Miller met with their West German counterparts in late September they were given a blunt message that further German support for the dollar was contingent on serious moves by the U.S. to lower the rate of inflation. Similar themes were sounded by international bankers and politicians alike at the International Monetary Fund meetings in Belgrade, where IMF Managing Director Jacques de Larosière took sharp issue with "gradualism" as an anti-inflationary strategy.

As rumors began to fly that a major move by the Fed was imminent, markets responded in anticipation. The dollar strengthened in foreign-exchange markets, and the price of gold dropped from its record high (accompanying chart). In light of such expectations, had the Fed not taken decisive action, it would have risked triggering sharp deteriorations in these and other markets.

The October 6 policy package—which con-



sisted of an increase in the discount rate to 12%, the imposition of marginal reserve requirements on a broad range of "managed liabilities," and a change in the procedures for conducting open-market operations—has received broad support from financial and political leaders both at home and abroad. This general approval was not surprising, of course, since something clearly had to be done to alter expectations about inflation.

Widespread approval of the Fed's broad objectives does not, however, carry over to all of the details of what was done. And that, too, is not surprising, since the Fed of necessity adopted its far-reaching measures without much time for deliberative analysis. Indeed, Fed officials have been remarkably candid in admitting that their new operating procedures will involve learning by doing. Even now, it is by no means clear how some of the technical challenges that the Fed has created for itself will ultimately be resolved.

Procedural perplexities

The change in procedures for conducting open-market operations has been the most significant of the new policies in terms of its impact on financial markets, which are having to learn to live with much wider daily fluctuations in the Federal funds rate. The new procedures —under which the Fed now focuses its attention on the quantity of reserves supplied to the banking system rather than on the level of the funds rate—should lead to better control over the money supply in the long run. However, the immediate consequence of the extreme uncertainty created by the new procedures was a very unsettled state of conditions in securities markets. These conditions were exacerbated by the unfortunate errors in the weekly money-supply figures which led market participants to expect even further tightening moves by the Fed. Heightened uncertainty may help to reduce inflationary expectations by raising doubts as to whether the Fed will validate future wage and price increases, but it is by no means clear that the extreme degree of turbulence generated—and the accompanying sharp declines in stock and bond prices—was necessary.

With the funds rate typically trading in the 14%-16% range since October 6, while the discount rate is at 12%, the temptation for member banks to borrow reserves from the discount window rather than in the funds market has been great. Indeed, member bank borrowings in recent weeks have been several times the average level of the past year. Heavy and continuing use of the discount window by member banks could cause operating difficulties for the Fed's new objective of achieving close control over the growth of bank reserves. The Fed, therefore, may be planning to rely on "moral suasion" to discourage banks from borrowing week after week. However, policing use of the discount window that way—when the discount rate is "below market"—has not been notably successful in the past. It thus may become necessary for the Fed to move to some form of a "floating" discount rate in order to reduce adequately the incentive to borrow. The alternative would involve the confusing complication of possibly frequent and sometimes large changes in the discount rate, with attendant "announcement" effects the Fed presumably would wish to avoid.

The third element of the new policy—an additional 8% reserve requirement on increases in a broad range of "managed liabilities" over a base amount—is in principle the most questionable. The Fed's concern over these liabilities and, hence, its desire to curtail their growth,

stems from the fact that they had financed about half of the rapid increase in bank credit in the three months ended September. But the efficacy of such requirements in restraining aggregate demand (and, hence, diminishing inflation) is extremely dubious, since they impinge only on credit extended by member banks. Past experience with similar actions suggests that their chief effect could be simply to reallocate borrowing and lending activity away from member banks rather than to reduce substantially the rate of growth of total credit, and it is the latter, of course, which is relevant in the fight against inflation.

Going it alone?

The impact of the new policies so far has been mixed. The dollar has strengthened impressively in foreign-currency markets, the price of gold has settled into a much narrower trading range, and the prices of a number of other commodities have fallen. However, a new round of disintermediation has begun, as can be seen from the high percentage of noncompetitive tenders at recent Treasury bill auctions and the reports of large withdrawals of savings deposits from thrift institutions.

It is clear that, in the longer run, the Fed cannot hope to mount a successful anti-inflation campaign all on its own, a point which Arthur Burns emphasized in his recent Belgrade address at the annual meeting of the IMF. Prospects for success of the new anti-inflation initiatives will depend crucially on the actions of Congress in the fiscal and regulatory areas, as well as on the degree of restraint to be shown by OPEC in December. Meanwhile, the risks of a serious recession have been enlarged by the October 6 package. Certainly the Fed will have to be skillful in avoiding overkill—particularly in view of the fact that monetary policy works with a considerable time lag—if it is to avoid inducing a political backlash which could adversely affect policy formulation for an extended period.

Gold's New Glister

For the first time since Bond had known Goldfinger, the big bland face, always empty of expression, showed a trace of life. "Mr. Bond, all my life I have been in love. I have been in love with gold. I love its color, its brilliance, its divine heaviness. I have worked all my life for gold. I ask you, is there any substance on earth that so rewards its owner?"

—Ian Fleming in *Goldfinger*

THE number of Goldfingers in the world suddenly seems to have multiplied enormously. Heavy—even, at times, frantic—demand for the yellow metal in recent months has been characterized as the "Great Gold Rush of '79." People have been clamoring to buy gold coins, bars, and "paper bullion"—gold futures.

The scramble for gold pushed its price to a recent peak of close to $450 an ounce, nearly double the market price at the beginning of the year. Even the stern measures of monetary restraint announced by the Federal Reserve in early October have not markedly deflated the gold bubble; gold prices have stubbornly held right around $380 an ounce (chart on page 5). Moreover, the price of gold has skyrocketed this

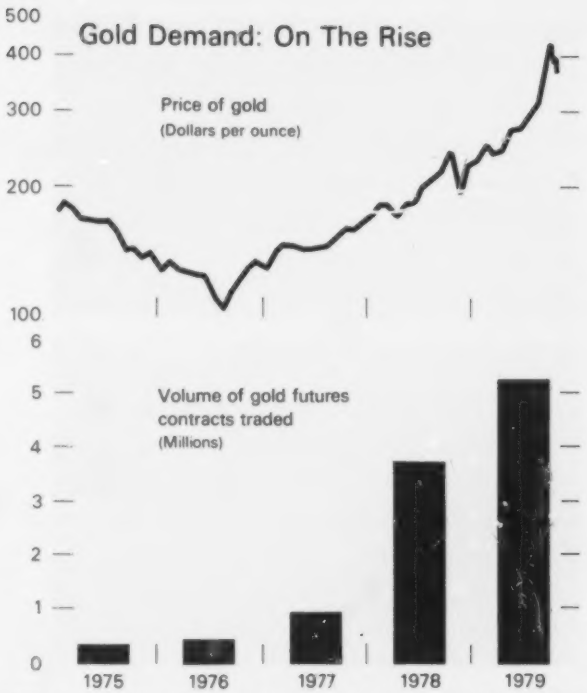
year not only in terms of the dollar but also against all other major currencies.

Contrary to times past, the steep rise in gold prices has failed to meet much resistance. Demand by industry and by investors for gold bullion and coins has not shown its earlier tendency to drop off. There has been, indeed, what J. Aron Commodities Corporation has termed a "perverse demand elasticity"—with higher prices seemingly abetting rather than discouraging appetites for gold.

Gold's new glister without question is due in part to the properties so admired by Mr. Fleming's fictional Goldfinger. For centuries, people have been enamored of gold's distinction as a substance. It's pleasing to look at, bright without being flashy, and coins made of it give off a pleasingly solid clink. Gold is easy to identify, impossible to counterfeit (though not for lack of trying by alchemists over the centuries). Gold doesn't deteriorate with time. It doesn't shrink or expand with changes in the weather. It has always been scarce enough to be much craved and never to be for long in surplus.

Quite aside from its physical properties, gold long has been sought after as a "store of value" against the ravages that inflation wreaks on paper currencies. With worldwide inflation on the ascendancy and with economic uncertainty on the rise, a flight from paper money to the yellow metal, not surprisingly, has ensued. A feverish gold price, thus, can be considered a kind of barometer of monetary fear that signals a need for corrective action. Rising gold prices reflect lowered confidence in government and dramatize the need for monetary and fiscal responsibility.

J. Aron Commodities, in its recent review of precious metals cited earlier, attributed much of the demand for gold by investors to the belief that leading countries have not found a way out



NOTE: Last plotting for the price of gold is October 29; gold futures volume for 1979 plotted as of October 26.

of the "stagflation dilemma." The report noted that, so far as the U.S. is concerned, skepticism about the latest anti-inflation stand has not been overcome: "Recent tightening moves under Mr. Volcker's aegis have been widely welcomed. However, so far at least, these moves have not dispelled the impression that Washington's anti-inflationary stance is frail, and may prove transient in the face of mounting pressure to combat recession."

J. M. Keynes, the British economist, decidedly did not share Goldfinger's fascination. Lord Keynes considered gold to be a "barbarous relic" thoroughly unsuited as a base for the modern-day world monetary system. He ridiculed the digging up of gold in one place only to bury it again in a hole in the ground someplace else.

Most major governments of the world tend to be on the side of Lord Keynes when it comes to

gold. The monetary role of gold, both domestically and internationally, has been declining steadily over many years.

The path leading away from gold has been followed for a variety of reasons. Governments did not especially appreciate the rigid discipline exerted by a gold standard. Because monetary and credit policies had to be based on changes in gold reserves, the gold standard imposed severe limits on governmental spending programs. New gold production has always been limited and quite "inelastic"—that is, higher prices for gold do not dramatically change the total available supply. Industrial demand for gold, all the while, has kept growing as world output has grown. (Sources of gold moving into world markets and estimates of their uses are shown in the accompanying table.) What's left —residual supplies of gold available for monetary use—have been inadequate for, and unrelated to, needs of the world economy.

Faced with that reality, the international monetary system has been steadily reducing its ties to gold—and its gold holdings, as well. The quantity of gold in monetary reserves of noncommunist nations hit a peak in 1965; it has declined steadily ever since (table on page 7). Compared with 1972, for example, world official gold reserves have dropped by 43 million ounces.

Key action to further demonetize gold in the world monetary system was signalled in a move more than a decade ago. In July 1969 the Articles of Agreement of the International Monetary Fund (IMF) were amended to authorize the issuance of Special Drawing Rights (SDRs). These were transferable reserve claims on the IMF which were promptly tagged "paper gold." Member countries undertook obligations, in amounts related to their quotas in the Fund, to accept SDRs from each other. The SDRs were given an initial gold value of $35 an ounce. The amendment, thus, gave the IMF the power to issue new international reserves—subject to the approval of members having 85% of the vote.

World Supply and Demand for Gold

(Millions of ounces)

	1975	*1976*	*1977*	*1978*	*1979*
Mine production in noncommunist world	30.6	31.1	31.1	31.2	31.5
Supply flow from communist countries	4.8	13.2	12.9	13.2	10.0
Net official sales	0.3	1.9	8.6	11.6	18.0
Total supply	35.7	46.2	52.6	56.0	59.5
Distribution of supply:					
Industrial fabrication	23.5	38.5	40.7	41.6	38.0
Official coin	7.8	5.9	4.4	8.3	9.0
Net private bullion purchases	4.4	1.8	7.5	6.1	12.5

SOURCE: J. Aron Commodities Corporation

Significantly, in July 1974 the value of the SDR was changed from an imputed gold value to the combined market value of a "basket" of 16 major currencies, weighted by the relative importance of the issuing country in international transactions.

But it was last year—in April 1978—that the status of gold in the IMF was changed more radically. The change was described this way in the 1978 Annual Report of the Fund:

> Members may no longer define for purposes of the Fund the exchange value of their currency in terms of gold; the official price of gold (SDR 35 per fine ounce) has been abolished, and members are free to trade in and account for gold at any price consistent with their domestic legislation. Members are no longer required to pay gold to the Fund in connection with any trans-

action or operation, and the Fund may accept gold from a member only by a decision that requires a majority of 85% of the total voting power . . .

The IMF no longer buys gold; indeed, it has been an important supplier of gold to the commodity market for gold. Its gold sales program, under which 50 million ounces (1,555 tons, equal to one third of its gold reserves) are to be sold over a four-year period, will be completed next May. One half of this amount is to be sold to countries that were members of the Fund on August 31, 1975 in exchange for their currencies, and the profits from the sale of the other half are to be used for the benefit of developing countries. So far, $3.1 billion has been channeled into a special trust fund for low-interest loans to the poorer nations.

All this is not to say that the world's monetary authorities have totally turned their backs on gold. The U.S., along with all other countries, recognizes that gold remains a significant asset even though it is gradually being phased out of the monetary system. A few countries have used gold reserves as collateral for loans. Others have sold gold on occasion to acquire foreign exchange for balance-of-payments needs.

Gold, too, plays a role in the new European Monetary System (EMS), a regional international monetary institution which began operations in March. EMS has adopted a transferable book claim: the European currency unit (ECU). The ECU's value equals the combined market value of fixed amounts of specified currencies of the nine members of the European Community.

Members of the EMS have agreed to deposit 20% of their reserves of gold and 20% of their reserves of dollars in a European Monetary Cooperation Fund. ECUs are then issued to members against these deposits and can be used, in part at least, in EMS settlements. Some monetary experts suggest that the EMS may facilitate some use of gold, indirectly, in settlement of payments among EMS members—thus "enthroning" gold to some degree.

Free World Gold Reserves

(End of period; millions of ounces)

	1976	*1977*	*1978*	*June 1979*
World	1,164.0	1,154.7	1,146.5	1,134.4
International Monetary Fund	149.5	131.6	118.2	114.9
IMF members				
All countries	1,009.9	1,011.7	1,018.5	1,010.5
Industrial countries	849.3	857.0	860.4	852.1*
Other Europe	52.3	49.2	47.5	47.5
Australia, N.Z., S. Africa	20.1	17.4	17.6	17.5
Oil exporting countries	37.0	34.4	36.2	36.4
Other less developed countries	51.3	53.7	56.7	57.1
Other	4.6	11.4	9.8	9.0

*Includes holdings of 80.5 million ounces in European Monetary Cooperation Fund.

For the world monetary system, however, the major point is that, in the Seventies, gold for most countries has become a relatively dormant reserve asset. The settlements of international payments accounts, rather, have been in foreign exchange holdings and in transfers of SDRs and other reserve-type claims on the IMF.

Even though the world's central banks have been able to buy gold in the market for years, they have refrained from making any substantial purchases since the U.S. stopped buying gold in 1971. However, there have been some

relatively small purchases, according to official figures, by oil-exporting nations and others (table on page 7). George H. Willis, deputy to the Assistant Secretary of the U.S. Treasury for International Affairs, estimated in late September that such purchases between 1972 and June of this year amounted to a total of about 5 million ounces among a dozen countries.

Rumors of an enhanced role for gold have been circulating for many months—that governments would restore a fixed price for gold, that OPEC interests have forged a joint gold-buying strategy, that the Arabs soon will put out a currency unit backed by gold. Such rumors, while fanning speculation, have lacked any supporting evidence. Saudi Arabian officials announced at the end of October that gold plays a "secondary role" in the investment portfolios of OPEC members and has no role in the Saudi Arabian investment portfolio.

In the U.S., as in the world monetary system, the policy thrust over many decades has been to move away from a gold-based money system.

The U.S. abandoned the domestic gold standard through a series of laws in 1933 and 1934. Those laws effectively removed the domestic monetary system's direct link with gold. Remaining vestiges have been eliminated in recent years. In 1965, for example, the gold backing behind member-bank reserves at the Federal Reserve was eliminated. Three years later the corresponding gold reserve against currency was abolished. In August 1971 the U.S. terminated the convertibility into gold of U.S. dollar claims held by foreign monetary authorities. Finally, in December 1974, this country repealed the prohibition on the holding of gold by private U.S. citizens.

The U.S. Treasury, like the IMF, has switched from being a buyer of gold to being a seller. In May of 1978, the Treasury began a program of gold sales—initially 300,000 ounces a month but raised to much larger amounts in subsequent months. This year 750,000 ounces have been auctioned each month. However, the Treasury announced on October 17 that henceforth, to keep speculators guessing, it plans to vary the amounts of gold offered and the frequency of the sales. As of the end of August, the Treasury's gold holdings were a little less than 267 million ounces, just under one quarter of global official stocks.

Such sales of gold have helped to reduce this country's large trade deficit. During the January-July months of this year, for example, official gold sales contributed to net exports of gold amounting to $900 million. Moreover, Treasury sales of gold have helped to reduce the government's budget deficit.

Sources and Uses of Gold in the U.S.

(Millions of ounces)

	1977	*1978*	*January-July 1979*
Sources:			
Domestic production[1]	2.1	2.4	1.4
Treasury sales	—	2.6	9.0
Net imports of bullion	7.9	4.4	−5.2
Gold coin imports	1.6	3.7	1.4
Total	11.6	13.1	6.6
Uses:			
Industrial and commercial fabrication	4.9	4.7	2.4
Commodity exchange stocks[2]	2.5	0.6	—
Coin purchases	1.6	3.7	1.4
Unexplained	2.6	4.1	2.8

[1]Refinery production which includes gold from U.S. mining output and old scrap.
[2]Includes gold held by dealers to back up trading on commodity futures exchanges.

The supply and distribution of gold in the U.S. is shown in the table on page 8. Domestic demand for gold, including demand for inventories and trading purposes, has been running about five times domestic production of gold. This leaves the country primarily dependent on imports of gold in the absence of sales from the Treasury gold cache.

Gold's future must be viewed through a split screen. Its role in the world monetary system seems likely to continue the pattern of many years: a gradual but persistent decline in importance. To be sure, the world-wide search for an anchor against the debilitating tides of inflation seems to have revived some interest in the virtues of gold as the dominant substance in the world monetary system. It is not hard to understand the growing desire for the stability that many associate with gold. Yet, in historical perspective, the gold standard belongs to an era in which economic affairs were left to be shaped by market forces, rather than by governmental intervention. The gold standard disappeared because people came to demand other objectives which were considered to be inconsistent with it and which at the time were deemed more important. In today's world, there seems little chance that nations will revert to acceptance of the mechanical rigidity of the gold standard.

Gold as a commodity—like wheat or pork bellies—is quite another matter. Clearly, the centuries-old mystique of gold remains locked in the minds and hearts of many—and not entirely without reason. The Vietnamese "boat people," using gold coins as a passport to freedom, provide the latest reminder of gold's utility in extreme conditions.

Gold will remain treasured for objects of adornment. Industry needs gold for many purposes. For example, satellites spinning through space will require gold coatings. Whether gold will retain its recent attraction for investors will depend most importantly on people's faith in paper money. A return to money that people could trust would in all probability put to rest the fever and frenzy that have pushed gold prices to recent lofty levels. For, given economic stability and a sound currency, gold would fight a losing battle with its worst enemy: compound interest. Gold pays no interest; unless its price rises, gold provides no financial yield.

The Revolution in Home Finance

HOUSING activity across the nation has been holding up at a relatively high level (with starts down at last count only 7% from a year earlier), despite a financial environment which in times past would have spelled disaster for the construction industry and its suppliers.

Some of the staying power for housing can be traced to conventional sources of strength such as rapid growth in the young-adult population. But a new and, in the short run, more powerful force has been at work: profound changes in the way housing has been financed in the last few years. Nothing short of a revolution in home finance has coincided with a strong demand for homeownership.

The continuing brisk demand for houses has been due, in important part, to deeply entrenched inflationary expectations. Clearly, a

desire to make a frontal assault on such expectations motivated the Federal Reserve's recent dramatic tightening of monetary policy. In this setting, it is questionable that even a revolution in home finance can shelter housing activity from a fairly pronounced slump.

Whatever happens immediately ahead, however, many of the changes in home-mortgage markets that have come about in the past several years will remain and shape housing's future. Chief among these is the growing integration of the bond market and once totally fragmented home-mortgage markets. That, significantly, has made home finance increasingly national in scope.

To understand the changes that have taken place in home finance, it is necessary to look back at the early postwar period and to recall the government policies that, in the conditions of those times, provided a climate favorable for homebuilding–one of the nation's greatest capital needs after World War II. VA guarantee of low-downpayment purchase of homes by returning GIs helped to provide that climate, and that underwriting complemented the similar FHA program begun during the Great Depression of the 1930s. Such programs, moreover, went hand in hand with the development of a system of tax incentives and regulatory restrictions on financial assets that created rapid growth in thrift-institution lending for homebuilding. Deposit insurance and tax deductibility for mortgage-interest payments (the latter only then becoming important for most middle-income families for the first time) were also important parts of the system. What thrived under those policies, and in the conditions of the times, was a set of specialized financial institutions "intermediating" between homebuyers and savers—a process that had as its central feature borrowing short (as most savings deposits had a formal 30-day maturity) and lending long (on 25- or 30-year mortgages). To be sure, the housing industry played a counter-cyclical role in the economy—for one reason, because it was impeded by ceilings on VA and FHA mortgage rates after the mid stages of economic expansions. But that cyclicality, in general, was viewed as stabilizing of the economy at large. And, in any case, the declines in housing activity that occurred during the 1950s and early 1960s were relatively modest in comparison with subsequent slides.

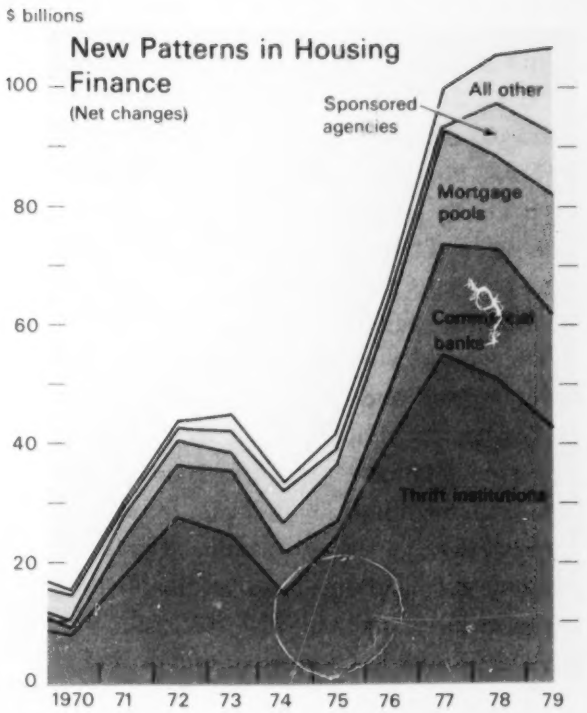
By the mid 1960s, however, the nation's system of home finance had become subject to stress as a result of inflation. That was because savers came to appreciate that regulatory ceilings on the returns that could be paid on savings deposits by financial intermediaries, in an age of inflation, were eroding the "real" value of their savings. Extension of such ceilings to thrift-institution savings deposits in the mid 1960s, in the final analysis, was jerry-built. The result of this regime, inevitably, was the now-familiar process of disintermediation: savings withdrawals in search of higher yields available in direct money-market investment—a process soon followed by mortgage-market illiquidity and sharp drops in housing activity. In 1969, when the starts rate fell some 25% during the year, and again in 1974 when the earlier peak in the starts rate was cut by more than half, the U.S. government stepped in to play a major intermediary role in the financial vacuum. The federal home loan banks and the Federal National Mortgage Association (FNMA)—or "Fannie Mae," the eldest daughter of what is now a whole family of government-sponsored credit agencies—were the main vehicles. FNMA provided support by purchasing government-underwritten home mortgages in secondary markets; the home loan banks, by extending ad-

vances to thrift institutions. Such government support, however, was not sufficient to make up for the inadequacy of an institutional structure that had been built for another time and other circumstances. The deep declines in housing starts that occurred in those years testify to the inadequacies of the system.

The core problem, of course, was inflation—in combination with a saving public that, understandably, was making efforts to protect its capital. For their part, thrift institutions have been adapting: for example, the largest of them have sought out new sources of funding such as Eurodollars. But the main adaptation has come in the form of lengthened savings-deposit liabilities and more attractive yields on longer-term deposits—something that was made possible by the gradual upward adjustment of interest-rate ceilings, especially those applicable to longer-maturity deposits.

The tying by federal regulations last year of interest-rate ceilings on six-month certificates in excess of $10,000 to the flexible and recently high-yield six-month Treasury-bill rate was only one more step in a whole series. It, like its predecessors, was designed to undo the damage to the financing of housing activity caused by the policy jerry-building of the late 1960s.

To be sure, in the climate of financial stringency that was evolving last year, the introduction of six-month certificates had a greater impact than did previous, more gradual, easings of interest-rate ceilings. Since their initiation in June 1978, such certificates issued by thrift institutions had grown in amount to $128 billion or some 20% of all savings deposits at thrift institutions. The certificates policy would not have been nearly so successful as it was in maintaining housing activity had it not been for many other factors, including liberalization of state-usury and VA-FHA ceiling rates. But what was most



significant, as noted earlier, was the combination of demand for homeownership and growth of a national home-mortgage market integrated with the bond market.

That growth, the way for which had been paved by investor experience with FNMA, evolved under the guiding hand of a whole set of federally related agencies—each with a specialized function. Particularly important were the establishment in 1968 of the Government National Mortgage Association (GNMA or "Ginnie Mae"), an integral part of the Department of Housing and Urban Development, and the creation in 1970 of the Federal Home Loan Mortgage Corporation ("Freddie Mac"), a private corporation within the nation's home loan bank system. Promotion of a genuine national home-mortgage market by Fannie Mae, Ginnie Mae, and Freddie Mac may even come to be viewed in the future as a change in home-finance practice as important as the long-term, low-

downpayment mortgages of the 1930s and 1940s pioneered by FHA and VA.

The extent to which home-mortgage markets are becoming integrated with the bond market and are moving toward national scope can be seen in the composition of recent increases in holdings of mortgages on one-to-four-family homes (chart on page 11). Thrift institutions continue to be the dominant investor in home mortgages, playing their traditional role of intermediating between homebuyers and savers. But the explosion in home-mortgage credit that has occurred in recent years has relied heavily on the agencies. First, as the chart indicates, there has been rapid growth in the home-mortgage holdings per se of U.S. government-sponsored agencies, principally FNMA—using the proceeds of funds raised in nationwide money and capital markets. As the chart suggests, the role of FNMA—ever since it was reorganized in 1968 as a privately owned but government-sponsored agency—has increasingly become that of permanent investor in mortgages. Clearly its function has been broadened from that of a mere provider of liquidity to home-mortgage markets through secondary-market purchases in times of disintermediation.

What is the much more novel feature of the current period is the rapid growth of so-called mortgage pools against which are sold "pass-through" or "bond-type" securities. Such growth has been due in large part to sponsorship—largely in the form of guarantees backing the mortgage pools—by Ginnie Mae and Freddie Mac.

Under the GNMA pass-through program—now a $60-billion one—mortgage originators such as thrift institutions and mortgage bankers sell off their claims to VA-FHA mortgage proceeds or cash flows (raising funds for new mortgages in the process). The cash flows, comprising principal and interest as they come due, are passed through to investors, including institutional investors such as pension funds, which have bought the securities.* Principal repayments vary, of course, depending on the turnover pattern of home sales. But the cash flows—because they are from a pool of mortgages—are reasonably predictable nevertheless. The predictable cash-flow feature, plus elimination of any need to scrutinize the creditworthiness of individual homebuyers, has made investment in home mortgages increasingly attractive to institutional investors. The securities backed by home mortgages thus bring added liquidity to VA-FHA mortgages, at no direct cost to the government, and in doing so are the natural ally of six-month savings certificates in blunting the impact of disintermediation on housing activity. The securities are actively traded in secondary markets—another attraction.

The Freddie-Mac program of pass-through-type securities, although much smaller than the GNMA program, is growing especially rapidly and has a similar impact on home-mortgage markets. From the point of view of the financial markets more broadly, the significant difference is that Freddie-Mac securities are based on pools of conventional mortgages—typically assets which in the past had not been traded actively in secondary markets and therefore were much less liquid to start with than were mortgages underwritten by VA or FHA. The credit backing of the U.S. government for the pooled Freddie-Mac mortgages, moreover, is not of the "full faith and credit" variety as it is in the GNMA case. Freddie Mac has also issued some bond-type securities, although in

*The originators of the mortgages in pools continue to service the mortgages—collecting a service fee. Homeowners are unaffected: they do not even know that the claims to the mortgages on their houses have been sold off. There are some 800 active issuers of GNMA mortgage-backed securities and over 33,000 pools. New issues last year financed over half of all new VA-FHA home loans.

much lesser volume than its pass-through type.

Mortgages underwritten by the Farmers Home Administration (FmHA)—an agency of the Department of Agriculture—are also an important part of the market. At present, FmHA mortgages, generated largely through a variety of programs that subsidize housing in nonurban areas, are sold in pools to the Federal Financing Bank (FFB)—an off-budget agency of the Department of the Treasury. Thus, FmHA pools (now about $14 billion) are radically different in character from, for example, GNMA pools—the ownership of which remains in the private economy. Such creative off-budget accounting, to be sure, stands as a support to home-mortgage markets. That type of support, however, is not new in character—except to the extent that, as FFB borrows from the Treasury to purchase FmHA pools, it does so at close to the Treasury rate—providing an additional level of subsidy indirectly to nonurban housing.

Additionally, several large home-mortgage generators recently have begun to issue pool securities backed by their own names. The volume of such activity—in imitation of federally related agencies—is still small, but it is bound to grow in the future as a body of experience grows.

What is perhaps the most noteworthy feature of mortgage-backed securities is that the intermediation, effectively, is one between long assets and long liabilities—in striking contrast to the more traditional funding of home mortgages with, say, short-term savings deposits at thrift institutions. As issuers of mortgage-backed securities in many cases, thrift institutions continue to play an intermediary role in this new process, but as claims to their mortgages are sold off, their role is radically transformed from the more traditional one. Their role is also transformed since they are also buyers of mortgage-backed securities issued by other thrift institutions as well as by the mortgage bankers.*

The underlying cause

As is clear from the record, the federal government has played a central role in the creation of change in home finance. But so has the marketplace. New contractual arrangements that have attracted new sources of funds for homebuilding would never have done the job alone. It has taken attractive rates on mortgages—rates which, of course, have been reflected in the yields on mortgage-backed securities and on FNMA issues. And such rates, in turn, have reflected in large part the demand for homeownership. Home sales, of new and existing homes, as well as single-family-home starts—although down some this year—had been setting new records in 1977 and 1978. With inflationary expectations so entrenched, and with housing values soaring, it is no accident that the high level of residential construction in recent years has been concentrated in single-family homes. Construction of apartments, meanwhile, has languished—and in fact has been running at only about half of the peak level set in 1972.

The upshot of these demand forces has been that home-mortgage rates have been substantially above yields on high-quality corporate bonds over an extended period for the first time since the late 1960s. Mortgage yields during 1977 and 1978 averaged some 70 basis points above yields on AA corporate bonds, a spread not seen since the late 1960s.** And, until recently, that pattern of substantial spread con-

*The new securities have been purchased by pension funds, insurance companies and individuals as well as by banks and other depositary institutions. There are, however, no detailed data on ownership since a large part of the securities is held in the names of nominees.

**The comparison is based on the series on effective rates on conventional loans, published by the Federal Home Loan Bank Board, and on Moody's AA corporate bonds.

tinued this year. The spread has not been so high as it was during the 1960s, it is true, and spreads were even higher in the 1950s. During the latter period, of course, the nation's shelter needs were especially critical; its capital stock of plant and equipment, in contrast, had emerged from World War II less scathed by wartime production policies; and equity financing was much more popular than it is today.

For the 1970s, the large positive spread of the past few years is a new development. In any case, when comparing present spreads with those of the past, it must be remembered that the relative creditworthiness of single-family homebuyers has been much higher in recent years. This is reflected, among other ways, in the dynamic growth of exceedingly low-cost private home-mortgage insurance (in imitation of FHA and VA). The high level of home-mortgage rates played an important part as well in the renewed interest of commercial banks in direct home-mortgage investment—an interest indicated in the chart on page 11.

Looking ahead

The degree to which new financial arrangements will be able to help sustain housing activity in the coming year or so obviously cannot be evaluated in isolation. As noted, the arrangements have thrived because of underlying market conditions. But these stand to change significantly as borrowers, intermediaries, and ultimate lenders assess the changes that have occurred in Federal Reserve policy in the past month—changes that continue to bring interest-rate pressures that are all upward. With home-mortgage rates commonly in the neighborhood of 12% to 13% at present, more and more would-be homebuyers, of both new and existing homes, are being eliminated from the housing market on grounds of affordability. With financing costs the dominant portion of carrying a house, this will remain true even if home prices level off or decline in coming months.

Moreover, since most buyers of houses also sell their previous dwellings, the impact at current rates on the demand for homes must be viewed in relation to the mortgages that will be cancelled in the buying-and-selling process. With rates on outstanding mortgages far below the current market, at the margin the cost of borrowing to finance the purchase of a house in many cases jumps sharply. Costs at the margin are especially inhibiting in an atmosphere of greater uncertainty about income and employment prospects and the ability to handle enlarged debt. These are two reasons among many why simplistic calculations of "real" or inflation-adjusted interest rates are a misleading analytical tool.

Problems are growing, too, for suppliers of mortgage funds. At the present level of rates, the inflow of funds into thrift institutions is being increasingly threatened by the attraction of regular depositors to money-market mutual funds. Heavily invested in bankers' acceptances and bank certificates of deposit, such funds—while contributing in recent months to the rapid growth of bank credit—have intensified the squeeze on home-mortgage credit. The pressures on mortgage rates that have already occurred, moreover, have resulted once again in a clash between market rates and VA-FHA ceilings, and between market rates and state-usury ceilings in many states—bringing lending in some states to a virtual halt.* Despite large increases in mortgage rates that are uninhibited

*Sixteen states have usury ceilings on home mortgages of 13% or below; several others have them tied to rates on open-market paper, but with a lag.

by ceilings, corporate bond rates have risen even more rapidly in recent weeks, thus narrowing the earlier spreads of mortgage rates over bond rates—something that for now has tended to diminish the relative attractiveness of mortgage-backed securities. Still another consideration is that in the process of originating or otherwise assembling pools of mortgages, the issuers of mortgage-backed securities—unless they had hedged themselves, say, by obtaining forward commitments from purchasers—have been at risk in a climate of rapidly rising interest rates.

Responses on the part of suppliers of home-mortgage credit—such as even more aggressive increases in mortgage rates—would result in further weakening in the demand for homes. In these circumstances, advances by the federal home loan banks will be called upon even more than they already have been to fund existing commitments. That may serve as a stopgap for several months, but a decline in commitments is inevitable. All in all, in current circumstances, a sharp drop in housing activity is highly likely in coming months.

Housing in the 1980s—a policy direction

What kind of housing and associated financial markets develop during the 1980s, and how federal policies guide that development, will remain uncertain until it becomes clear just how deep next year's slide in homebuilding will be. Breaking inflationary expectations is the key to the outcome, to be sure. But so, also, are the demographics. The entry into single-family-home markets of the "baby-boom" generation of the 1950s and early 1960s will continue. And thus it is probable that the underlying demand for houses will be strong and that rates on home mortgages will tend to be relatively high in comparison with rates on long-term securities generally. Such conditions would support ongoing active interest of institutional investors in home mortgages in a growing national market. That environment, furthermore, would undermine whatever logic might remain in a regime of interest-rate ceilings on deposits under which most savers still suffer. Since savers remain, ultimately, the major financiers of housing, they indeed would have a claim on high mortgage yields as much as would the new intermediaries.

At the same time, should demand for homes be high during the 1980s, and should private mortgage insurance continue to thrive, there would be less and less need for the federal government to be involved in programs that have been channeling financial capital into providing housing for the nation's broad middle-income groups. There would be, for example, no compelling reason for FHA and VA underwriting to exist as a continuing activity of the federal government. There might even be a time when it would be justified for the government to sever completely its link with FNMA and other sponsored home-credit agencies, maintaining only a regulatory function.

Such a direction would give Washington an opportunity to concentrate its limited energy and other resources on promoting improvement of the dilapidated housing and neighborhoods of the nation's poorest families. For the most part, the U.S. housing stock has become the envy of other industrial countries. But many large pockets of decay in urban and in rural areas remain in the U.S.—to a much greater extent than in most other rich countries. Increasingly in the future, it should be possible for the government's concern with housing—heretofore very far-reaching—to have a considerably more concentrated focus on the housing deficiencies that the marketplace has not been effectively remedying.

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The Economy at Yearend—Review and Outlook

As it began, 1979 is ending heavily conditioned by events in Iran. Their effects, direct and indirect, on the U.S. economy have been significant and obviously have the potential to be considerably more far-reaching. At a minimum, unsettled conditions in world oil markets, coming on top of other sources of weakness, could well contribute to deterioration in economic performance not only in the U.S. but in the world economy as well.

Despite the Federal Reserve's frontal assault on inflationary expectations, the prospects for sharply reduced inflation remain bleak. Since inflation expectations are deeply held, and since the disturbing Iranian backdrop presumably has driven them even deeper, the strong possibility exists that inflation psychology will recede only slowly. If that turns out to be the case, most of the initial effect of credit restraint will fall on "real" output—insuring a recession of considerable scope and intensity in 1980.

Looking back, the prevailing view of economists a year ago was that 1979 would bring, at best, a sluggish economic performance. And many forecasters felt that, by the latter half of the year, the pace of advance would slow further, tipping the economy into a mild downturn.

A weakening of the economy was seen as likely in part because the expansion, even in its late stages, had relied heavily on credit buying—with consumers piling up record installment and mortgage debt in relation to income at a pace that could not be sustained. Additionally, the upswing was showing some signs of stress: capacity limits were being tested for both labor and capital resources and price pressures were intensifying.

Against those weaknesses, however, there were conspicuous sources of strength. Capital investment activity, for a variety of reasons, had gathered momentum late in the cycle and 1979 seemed to be shaping up as a year of continuing strong investment performance. Moreover, inventory data gave no signs of gross imbalances. Lastly, the depreciation of the dollar in 1978, along with quickening expansion among key industrial nations, was counted on to sustain a pattern of improvement in U.S. trade.

It was the last—U.S. trade—that turned out to be the star performer in helping to offset weakness in household-sector spending. Strikingly, merchandise exports surged well ahead of the rise in imports other than of oil, with the result that the annual rate of surplus on U.S. non-oil trade in the three months ended October rose to $38 billion—up from $18 billion in the year-earlier period. That improvement, in fact, was almost as large as the $28-billion increase that occurred in the dollar volume of U.S. oil imports. Substantial improvement in "invisibles" accounts (due mostly to higher earnings on U.S. investments abroad) also made an important contribution to this country's ability to pay for an unexpectedly large increase in its external oil bill. Measured by the current-account data, the very small external deficit incurred in the fourth quarter of 1978 had not changed materially by the third quarter of this year. The GNP data tell a similar story about the supportive influence of U.S. exports: in real terms, the growth of net exports —an estimated $8 billion in 1972 dollars during the year—was in fact almost as large as the increase in final sales (accompanying table).

Among the surprises of the year was that the weakness in sales and production set in earlier than generally expected. The early weakness, however, clearly did not reflect conventional

Sources of "Real" Growth 1978 and 1979

	Change, billions of 1972 dollars		*Percent change*	
	4th Q. '77 to 4th Q. '78	*4th Q. '78 to 4th Q. '79 est.*	*4th Q. '77 to 4th Q. '78*	*4th Q. '78 to 4th Q. '79 est.*
Real GNP	65	3	4.8	0.2
Inventory investment	1	−8	(N.A.)	(N.A.)
Final sales	65	11	4.8	0.7
Personal consumption	39	4	4.5	0.4
Business fixed investment	14	4	10.5	2.7
Residential investment	0	−4	−0.2	−7.3
Net exports	7	8	(N.A.)	(N.A.)
Government purchases:				
Federal	−3	0	−2.5	0.0
State and local	7	−1	4.0	−0.3

NOTE: In some cases, totals do not add due to rounding. Percentage changes based on unrounded dollar figures. (N.A.) not applicable.

cyclical tiring. It was the product, rather, of a series of exogenous depressants: unusually severe winter weather at the very start of the year, the Teamster's strike in March, and the virtual shutdown of Iranian oil exports early in the year.

The loss of about 8% of noncommunist world oil supplies over a period of several months, to be sure, was made up in large part by expanded exports from other OPEC countries. But the influence on the U.S. economy of what in the final analysis was a modest world shortfall of oil supplies was nonetheless pervasive. A number of factors conspired to exaggerate the basic shortage: a hopelessly inefficient governmental allocation system; panic

buying of gasoline; and a necessary and prudent replenishing of depleted heating-oil inventories. All combined to bring about a marked drop in auto and truck sales and in travel activity—the main cause of the decline in real GNP that occurred in the second quarter of the year.

Upward pressure on interest rates

Meanwhile, interest-rate patterns in 1979 mirrored those of sales and production, first leveling out in the spring (when it looked as if an earlier-than-expected recession was materializing) but then rising again during the late summer and fall as the tempo of economic activity quickened again, as growth in the money stock spurted, and as inflation remained stubbornly high.

The very high rate of price advance that persisted throughout 1979—much higher than had been forecast by economists generally at the start of the year—was, of course, a critically important factor in prolonging upward interest-rate pressures. A variety of influences contributed to the surge in the price indices, but none was more important than what happened to oil prices. When OPEC ministers met in December 1978, they posted a rise of 15% in the price of a barrel of oil, and it was commonly assumed that that would represent the full extent of the 1979 advance. However, the failure of consuming countries to deal effectively with the modest shortfall that they faced created, among other things, intense pressures in the spot market and permitted the scheduled 15% increase to become 70%, as measured by the increase in the price of U.S. crude oil imports. (Moreover, in the U.S., the atmosphere of shortage created by the allocation system and by panic buying led the government to permit a widening in the margins between crude and product prices.)

The effects, of course, were widespread: on consumer prices; on foreign exchange markets, which saw renewed anxiety about U.S. inflation-control measures; on decisions made by policy officials abroad to respond with higher interest rates to their own countries' oil-related inflationary pressures and to deteriorating current-account positions. And, very significantly, the persistence of inflation—in combination with rapid monetary growth—critically influenced U.S. monetary policy, culminating in the bold package announced on October 6.

In short, the decisive influence making for upward interest-rate pressures during 1979 was the worsening of inflation and inflationary expectations—for reasons that had little to do with added capacity constraints. Economic growth was slow during the year, with utilization rates for both labor and capital resources actually having peaked in late 1978. What did materialize—and what was critical in making for higher interest rates—was pronounced difficulty in curbing credit demand via a policy of gradual upward pressures on interest rates. Gradualism in policy finally gave way.

Several key developments in recent months point to continued problems ahead. Surely, the most obvious of these is that the effect of the U.S.-Iranian clash on oil markets will remain for some time. With U.S. oil consumption already down this summer and fall about 5% from year-earlier levels, and with a conservation response to the siege at the U.S. Embassy in Teheran possible, coping with the loss of oil imports from Iran of some 700,000 barrels per day (bpd) should not be all that challenging. It would be quite another matter, however, if growing chaos in that country were to lead to an extended cut-off in Iranian oil exports to all markets (recently just over 3 million bpd).

In any case, pressures on world oil prices,

symbolized by a $40-per-barrel spot market, will remain strong for many months to come—making it increasingly difficult to foresee an early end to strong upward pressures on U.S. price indexes. With the U.S. external oil bill now some $70 billion at an annual rate, even a relatively moderate hike in world oil prices would represent a large added drain on the incomes of Americans.

Another concern—from the perspective of prospects for the world economy—is that, with the U.S. demonstrably in a relatively good position to pay its oil bill with current output (particularly on the assumption that recession occurs), growth of OPEC surpluses may well have as its chief counterpart growing current-account deficits in other countries. Indeed, such a tendency is already visible. Strikingly, the current-account position of Western European countries—in collective surplus of $25 billion at an annual rate in last year's fourth quarter—had turned into a deficit estimated at a rate of $16 billion by the third quarter of this year. Japan, moreover, reports a swing from an $8-billion rate of surplus to a $15-billion rate of deficit over the same period. A relatively weak yen, now about 250 to the U.S. dollar in comparison with some 200 to the dollar at the end of 1978, theoretically has put Japan also in a much better relative position to defend its current-account position from erosion. But many European countries—with relatively strong currencies and ongoing economic momentum—are not so well positioned (nor, of course, are those developing countries without oil resources). And interest-rate increases, to defend the external values of currencies, continue. Indeed, one of the key implications of the present desynchronization of economic and current-account trends in the U.S. and elsewhere is that interest rates abroad will tend to be sticky on the high side relative to interest rates in the U.S. This may well prove a serious complication for Federal Reserve officials: conventional accommodative policies in a period of falling output and rising unemployment would be circumscribed by continuing need to defend the external value of the dollar. The nervousness of dollar trading following the U.S. Government's freeze of Iranian assets highlights that constraint.

The tax issue

The nation's growing tax burden, though less publicized than oil, is also a major negative in the outlook for 1980. The issue of tax policy, of course, is both cyclical and secular. Should the U.S. economy weaken significantly in coming months, pressures would undoubtedly mount for a relatively quick tax cut. The secular need—that of basic reform of a revenue code that has become inimical to saving and investment—would then be in danger of receiving short shrift. At present, to be sure, there is broad bipartisan support for the notion that the long-run performance of the U.S. economy rests in large part on such reform. But there can be little confidence that such support will be maintained if cyclical weakness comes to dominate the debate about which taxes to cut and by how much. The increasingly tense international scene, moreover, may be reflected in the defense budget. And it is, of course, a truism that dollars committed to enlarged spending—be they for defense or for other purposes—limit the scope for tax cutting, whether for stimulative or reform purposes.

While inflation has worked perversely in adding to the burden of both personal and corporate taxation (box on page 6), it is at least true that the corporate tax burden did not increase sharply in the end phase of the 1975-79 cyclical

expansion as it did in 1974. This is so largely because inventory profits as a share of taxable earnings have not risen as dramatically lately as they did then. The rate of increase in prices of goods in inventory has not been so high, and many companies have switched to last-in-first-out accounting, which reduces the impact on taxable earnings of rising prices. Significantly, taxation of the economic profits of nonfinancial corporations during 1979 was at an estimated rate of 55%—high in terms of capital-formation objectives, to be sure, but basically unchanged from last year.* In 1974, by contrast, the rate of taxation of economic profits jumped about 20 points to exceed 70%.

For that reason and because investment spending in the past cyclical expansion was moderate, particularly in comparison with the boom of 1972-73, any investment downturn in the coming year stands to be less pronounced than it was during the 1974-75 recession. Inventory policy, moreover, remains governed by caution, as it was not in the year or so preceding that downturn. Outside of the auto sector, involuntary run-ups in stocks have been minimal. And inventory-to-sales ratios, although they have inched up in the past year, generally remain low in historical perspective. It should be noted, however, that targeted levels of such ratios are far from constant. High credit costs and uncertain prospects for final sales undoubtedly have lowered those levels. The break in the uptrend in commodity prices since the October 6 initiatives also suggests a rethinking of the wisdom of borrowing to finance inventories. Indeed, the perception of what are underlying real or inflation-adjusted interest rates—to the extent they can be measured, even crudely—presumably is undergoing reappraisal.

In today's conditions, however, it is much more likely that consumer spending and housing activity rather than business outlays will shape the near-term future. For the individual consumer, the battering from inflation will continue. With average wage rates up some 8% in the past year and increases in prices exceeding that increase, real purchasing power has slumped. Continued growth in employment has attenuated the decline in aggregate incomes, but, with inventory policy undergoing reappraisal, that support cannot be counted on for much longer. Nor can one readily assume a further drop in the saving rate, which by the third quarter had fallen to a near-record post World War II low of 4.3%.

Impact on housing

Homebuilding, moreover, is threatened with sharp cyclical decline, even though to date, despite an inhospitable financial environment, there has been only a limited reduction in housing starts (an estimated 15% in 1979 as a whole). Home-mortgage markets in recent months have become extremely illiquid as a result of many forces: poor deposit inflows at traditional home-loan institutions, high mortgage rates that have caused more and more would-be home buyers to drop out of the market, and state usury and FHA-VA ceilings which have not adjusted quickly to changing market conditions. Government supports to housing, as a practical matter, can do little to offset such fundamentals. And, if housing is in fact sharply affected by the financial constraints that have evolved, there is likely to be a downward pull on other sectors of the economy—especially on consumption activity. That is so

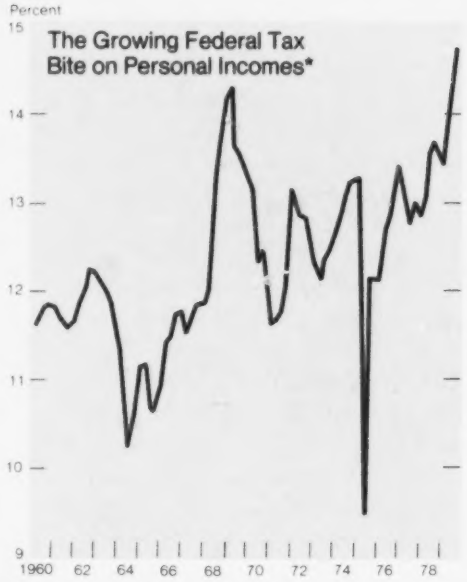
*Economic profits as defined in the national accounts are net of inventory profits or losses and treat depreciation charges consistently over time on an historical-cost basis. The tax rates cited above are based on domestic earnings, since repatriated earnings are viewed in the accounts as taxed at their source.

THE RISING TAX BURDEN

REDUCTIONS in federal tax rates over the years have not prevented an upward trend in the burden of taxation on individuals. There has been a gradual upcreep, too, in state and local income taxes.

The federal rate on income subject to tax has grown especially sharply in the past year, as it did in 1974 in a similar inflation environment. And, in fact, by the end of this year, the tax load by this measure was even higher than it was during the days of the Vietnam war surtax (chart). This upward bias is causing the federal budget to become notably less stimulative than it had been. Achieving a less stimulative budget is most assuredly a desirable long-term objective. But accomplishing it via the route of a higher burden of personal taxation is highly questionable—given the economy's need for greater incentives for work and saving. Rapid enlargement of the government's tax take is especially poorly timed, of course, with the economy on the brink of recession.

The corporate tax burden also has grown over time, what with the taxation of inventory profits under first-in-first-out accounting and inadequate provision for depreciation in an age of inflation. Based on economic profits (described more fully on page 5) of the nonfinancial corporate sector, which abstract from these influences, taxation at all levels of government during the 1970s has been at an average rate of 54%, up from 46% in the 1960s. As in the personal sector, the various ad-hoc cuts in corporate taxes during the 1970s—including rate cuts, investment credits, and improved depreciation provisions—have not done the job of preventing a mounting tax burden.



*Based on income subject to tax—defined as personal income plus employee contributions to social insurance trust funds, minus transfer payments and "fringe benefits." Fourth quarter 1979 is estimated.

because households in the last several years have been borrowing heavily against accumulated home-ownership equity and have used the proceeds of such borrowing for purchase of such things as home furnishings and consumer durables. A weak housing resale market would radically change the capacity for continued tapping of the home-equity till.

Additionally, the outlook for consumer spending has been adversely influenced by the sharp declines in securities prices that followed the October 6 change in monetary policy. The fall in stock and bond prices that ensued lowered the private sector's (including the household sector's) wealth embodied in long-term financial assets by some 10%. It is a reasonable

presumption that this has affected attitudes toward spending on both homes and consumer goods and services.

Such considerations point toward a pronounced softening in the economy and, in turn, to lower interest rates. And, in fact, money market rates have been backing away from their post-October 6 highs as signs of autumn malaise in retail activity have multiplied and in response also to a slowing of growth in the monetary aggregates. Strikingly, the annual growth rate for M_1 (currency and demand deposits)—5.1% in the past three months based on the average level in the four weeks ended November 21—was cut in half from its reading of three months ago.

If slippage in economic activity persists, as seems probable, interest rates should work lower and growth of the key monetary aggregates should continue to moderate. Also, better price performance can be expected. But, it is hard to foresee speedy progress toward a fundamentally improved price environment given the deeply rooted character of inflationary expectations and the absence of any signs that wage-determination patterns are changing. Rapid increase in labor compensation costs—with formal and informal indexing widespread—is a process of long standing, and one that, significantly, was little disturbed by the deep recession of 1974-75. Thus, while some progress in reducing inflation seems likely in 1980—especially as measured by the CPI—the degree of improvement stands to be limited and slow in coming (story on page 8).

Forecasts, at present, point predominantly to a recession much less severe than the 1974-75 version. The average or typical recession they project is not surprising, given the necessary reliance of econometric models on the economy's long-term or average behavior. The lack of gross imbalances in inventories and in investment activity broadly is certainly an important factor in such forecasts. Current conditions are far from average in any sense, however. So-called exogenous factors, ranging from the U.S.-Iranian tension to heightened uncertainty generally, which the best econometric equations cannot deal with effectively, indeed have put most of the risks on the down side.

Single-Digit Inflation Around the Corner?

THIS year's distressing surge in inflation has shocked consumers—and surprised economists. The latter, including practitioners in and out of government, early this year anticipated single-digit inflation in 1979. As it has turned out, the inflation pace—as measured by the highly publicized consumer price index—seems sure to run close to 13%.

Unfazed by that performance, the economics fraternity now is confidently predicting some goods news ahead on the inflation front: a return to single-digit inflation during 1980.

Before examining the basis for such an optimistic forecast—and its believability—it is necessary to dissect the inflation measures themselves. The amount of inflation the nation has suffered in recent months depends, importantly, on the price-change yardstick that is used.

Analysis of inflation is complicated by the fact that the two most widely followed measures of the general inflation rate—the consumer price index and the GNP deflator—are indicating very different rates of inflation for 1979. Usually these two indexes increase at approximately the same rate (chart on page 9), but in recent months their rates of increase have diverged significantly. In the past year (four quarters ended in September), the CPI has increased 11.7% while the GNP deflator has increased 8.8%. During the past six months, the difference in the indicated pace of inflation has been even greater—a 13.2% annual rate for the CPI and an 8.6% rate for the deflator. Thus, if the deflator is used as a measure of the general inflation rate only a relatively minor acceleration from the 8.2% increase shown in 1978 has occurred, while if the CPI is used an acceleration of over four percentage points from the 9% rise in 1978 has taken place.

Why the disparity? The answer lies in the significant differences in the way the two indexes are calculated. The CPI covers the prices only of consumer goods and services, while the deflator is a much broader measure: it covers the prices of investment goods and government output as well. And whereas the CPI is a fixed-weight index with the weights derived from a 1972-73 sample of consumer purchases, the weights used by the GNP deflator are continuously updated as spending patterns change.

Such conceptual differences have been a factor this year, although recently the really large difference is to be found in other causes. Among these, the measurement of housing costs has been particularly important. The two indexes handle the price of rental housing similarly—simply by sampling the rents that are actually being paid. However, the more important component of housing costs (because there are more home owners than renters) is the cost of owner-occupied housing, and this is treated very differently. In the CPI, the cost of owner-occupied housing is represented by a combination of the purchase price of houses and the mortgage interest rate. In the GNP deflator, the cost of owner-occupied housing is measured by an imputed value for rents. A theoretical argument can be made that the home ownership and rental markets are not compartmentalized and that price trends in one should approximate price trends in the other. But that in fact is not the case. Renters recently have been tending to get a bargain in relative terms because in this age of rapidly inflating property values owners of rental properties anticipate receiving part of their return from the increased value of their buildings. Of course, home owners also benefit from rising property values, but this

appreciation is not taken into account; the CPI confines its measure strictly to housing prices and mortgage financing costs. Significantly, in the past year (the four quarters ended September 1979), the price of owner-occupied housing in the CPI rose 20% while the rental proxy used in the deflator rose only about 8%.

A second major difference between the CPI and the GNP deflator that has been important in recent months is the measurement of prices of oil. The CPI takes account of movements in prices of both domestic and imported petroleum. The GNP deflator covers only the prices of domestically produced goods and services and, consequently, does not directly reflect the price of imported oil.

The technique used to exclude the price of imported oil (and the price of other imports as well) from the deflator requires two calculations. First, all goods and services sold in the U.S.—including those goods and services which contain imported oil or are produced from it —are priced. Then the price of imported oil is deducted. For example, if airline fares rise to reflect the higher cost of jet fuel produced from imported oil, the higher fares are picked up by the deflator, but the higher price of imported oil that was responsible for the fare increase is subtracted out, leaving the total deflator unchanged.

To be sure, a rise in the price of imported oil is likely to have indirect effects on the deflator. Most significantly, the price of the portion of domestic oil production that is not subject to price controls (about 20% of U.S. production) has risen in step with increases in imported oil prices. This, along with some more moderate increases in the price of controlled U.S. production, has boosted the average price of U.S.-produced oil by about $4.50 per barrel in the past year. This increase, of course, has been reflected in the deflator.

Another way in which higher import prices can affect the deflator is through wages. Higher imported oil prices are fully reflected in the CPI and, as a consequence, industries that have CPI-based cost-of-living escalation find that higher oil prices push up their wage costs. In turn, the price increases that these higher wages produce are reflected in the deflator.

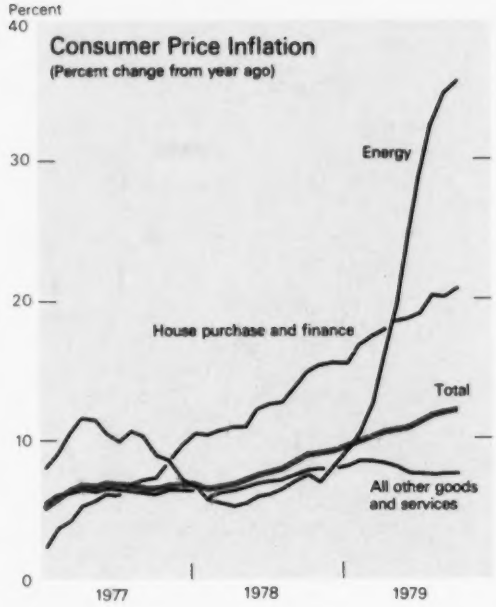
All in all, while the deflator is not immune to higher imported oil prices, it is clearly less sensitive than is the CPI, which reflects the direct as well as the indirect impact.

The bulk of the difference between the rates of increase of the CPI and the deflator in the past year is accounted for by the different treatment in the two indexes of housing costs and imported oil prices. If the GNP deflator were to be recalculated with imported oil included and with owner-occupied housing priced as it is in the CPI, the past year's increase in the

deflator would be boosted to 10.5% (compared with 11.7% for the CPI) and the increase in the past six months at an annual rate would be boosted to 11.6% (compared with 13.2% for the CPI).

All of the speed-up which has occurred in the CPI during 1979 can be accounted for by acceleration in the rate of increase of energy prices and of the cost of owner-occupied housing (chart on this page). The rate of increase in the remaining components of the CPI, which account for 75% of the total index, has actually decelerated slightly.

There is no definitive answer to the question of which index is the better measure of the rate of inflation. It is important to remember that price indexes are only proxies; all are deficient to some extent. The GNP deflator probably comes closest to a measure of what most economists would consider the general inflation rate because it is the broadest and most inclusive. The CPI, however, is important simply because it is the most widely followed index and therefore tends to be the primary conditioner of attitudes toward inflation. The CPI is also important because it is widely used to escalate wages both directly in union contracts and indirectly in the nonunion sector.



Outlook for 1980

Looking ahead to the new year, it seems likely that inflation will ease somewhat in 1980. Moreover, there is a good chance that the CPI will decelerate more next year than the deflator. This expectation is based most importantly on a projected drop in mortgage rates and a deceleration in the rate of advance of house prices as the housing industry feels the impact of increased monetary stringency.

To be sure, with some acceleration in wage rates possible in 1980—mainly because wages in the nonunion sector of the economy have tended to lag somewhat—and with productivity expected to continue to stagnate, general cost pressures may well intensify. However, any inclination businesses may have to accelerate price increases may be frustrated if, as seems likely, weakness in the economy grows more pronounced.

Even assuming acceleration in the rate of price increase in some sectors, the odds would still favor deceleration in the over-all CPI in 1980. That judgment flows partly from the fact that energy could be less of an upward propellant in the CPI even if the international price of oil goes up as much next year as it has this year. The table on page 11 indicates why. It breaks the retail price of gasoline and heating oil into two components—the cost of crude oil and the margin between crude costs and retail prices. Crude costs are measured by the

average price of crude delivered to U.S. refineries; retail prices are measured by the consumer price index. The table shows that about half of the increase in petroleum product prices between the fourth quarter of 1978 and the third quarter of this year reflects higher crude oil costs and the other half reflects a widening of margins. The higher margins have resulted from the tight oil markets, higher noncrude costs, and changes in pricing regulations by the Department of Energy that have allowed wider margins for refiners and retailers of gasoline.

Petroleum product margins are unlikely to repeat their sharp increase of the past year even if crude oil costs continue to rise. That would help check the climb in the over-all CPI. And it is also possible that this year's especially large crude-oil price increase—amounting to about 75%, fourth quarter to fourth quarter—will not be repeated. If OPEC prices should rise by, say, an additional 30% to an average price of $30 per barrel, if domestic crude prices rise 60% as a result of phased decontrol, and if margins remain constant, product prices would then rise about 20 cents per gallon, compared with the 35-cent increase this year. Consequently, chances appear good that energy prices will contribute to a slowdown in the rate of CPI increase during 1980.

Similarly, the chances seem fairly high that the rise in the home-ownership component of the CPI will slow significantly. That is not an immediate prospect, since the monetary tightening by the Federal Reserve is currently pushing mortgage rates upward. However, by the spring of next year, at the latest, mortgage interest rates should have at least stabilized, and the greater likelihood is that they will be moving lower as softness develops in housing markets. And it is not unreasonable in a weakened housing market to anticipate some slowing in the sharp climb of house prices—up 15% in the last twelve months. Although a slowdown in inflation—as measured by the CPI—seems a reasonable prospect, such a forecast, assuming it turns out to be accurate, is no cause for jubilation. The GNP deflator—a better measure, in many respects, of general inflation—is expected to show little if any deceleration. The grim fact is that there is as yet little reason for encouragement about the possibility of fundamental improvement in the economy's basic cost situation. Even with recession in sight, there is no ground at present for forecasting any significant slowing in the trend of hourly compensation; nor can there be much hope for early revitalization of the economy's productivity performance. So, continuing pressures loom ahead on costs per unit of output.

Thus, even if the CPI should recede to a single-digit pace, no one should be deceived by that alone into concluding that a fundamental turn for the better has occurred in the war against inflation.

Crude and Petroleum Product Prices

(Cents per gallon)

	Gasoline			*Fuel Oil*		
	Retail[1]	*Crude*	*Margin*	*Retail*	*Crude*	*Margin*
1974	53.0	21.5	31.5	37.4	21.5	15.9
1975	56.6	24.7	31.9	40.5	24.7	15.8
1976	59.0	25.9	33.1	43.4	25.9	17.5
1977	62.4	28.5	33.9	49.2	28.5	20.7
1978	65.1	29.6	35.5	52.1	29.6	22.5
1978-4Q	67.6	30.4	37.2	53.9	30.4	23.5
1979-3Q	96.5	46.5	50.0	80.3	46.5	33.8

[1] Average of all grades.

Mouseville and the Great Wave

IT was a hush-hush, super-secret meeting in Mouseville's town hall. No chance had been taken that word of the meeting might leak out. Behind locked and guarded doors, the Chairmouse rapped for attention.

"Sorry to call you out of your nests at this late hour, but we've got a problem. Our citizenry is getting extremely jittery. There is growing apprehension that we are about to be inundated by the Great Wave."*

Gasps filled the room. Nothing chilled the hearts of Mousevillians like a mention of the Great Wave—even though it had not flooded the area since 1929. That had been a time of privation and suffering. The Great Wave had swept away their jobs, their farms, their nests—even some of their lives.

"Say it isn't so," quavered one voice. But some were made of sterner stuff. "Hold on," commanded a councilormouse at the far end of the table. "Who says the Great Wave is about to spill over? Any verified evidence?"

The Chairmouse shook his head vigorously, his whiskers whipping in the breeze. "No actual sightings, but some signs—froth and churning in the Euro-rallod pool, OPEC-induced riptides that have our poorer cousins in the animal kingdom sputtering and gasping for air."

"Nothing more than that?" the skeptic persisted.

The Chairmouse, beginning to smart under the challenge, lashed back: "I quote to you the recent words of the all-knowing volckermouse: 'The standard of living of the average Mousevillian has to decline.' "

That brought a quick scoff from the back of the room: "That's as if a reveremouse rode through our streets warning, 'The lions have been here, the lions have been here!' "

The council table erupted in sound as the members all began squeaking at once—some in laughter, some in anger. The bankermice, it was observed, took great pains to appear neutral—a stance not uncommon at the mere mention of a fedmouse.

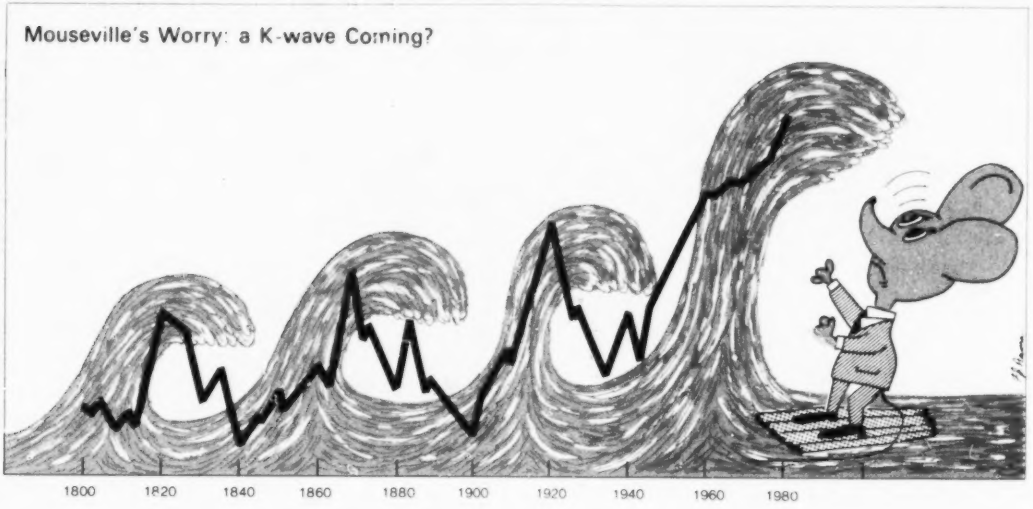
Warning flags

The Chairmouse rapped for quiet. "Gentlemice, let me remind you that the storm warnings *are* in evidence. The cheese price is close to 400 rallods an ounce, an historic indication that Mouseville and its environs have entered troubled waters. Consider the plight of the average Mousevillian—he's awash in debt and keeps sinking deeper every month. And with distressingly high inflation gnawing away at our ability to stay afloat it's no wonder that many mice are jumpy."

The Chairmouse paused, saw the audience was hanging on his every word, and then continued his lugubrious litany. He noted that speculative mania had become widespread. Mouseville had become a nation of pack rats, stashing away diamonds, cheese coins, paintings, antiques—anything except paper rallods. Recent admonitions from the White Nest—that fear itself was the only real fear—had a familiar ring. But the effect was to evoke memories of the Great Wave. The statements, thus, had proved less than reassuring.

A species of forrestermouse from M.I.T. (Mouseville Institute of Trapology) leaped into the verbal fray: "Yes, and all this comes at a time when we are crowding our limits on land—of pollution, of resources, of energy. Social lim-

*Named after a bear named Kondratieff, who developed that watery theory early in the century.



its, too, are being breached. In many places you see signs of stress, community breakdown, rising crime rates, drug addiction—all of it worsened by crowding that is approaching sardine levels in some places. In short, gentlemice, after many decades of waterproof growth we have now triggered strong counterpressures."

"Fiddlesticks," snarled a voice at the end of the table. "You nervous nellies are seeing mountainous waves behind every sand dune. I've heard those warnings, off and on, for 25 years."

That comment was greeted by much paw clapping and supportive swishing of tails. It was comforting to hear that reports of the Great Wave not only were exaggerated but old hat as well.

Opponents of the Great Wave theory hastened to the attack. From an economouse famed for his study of wave cycles in the seven seas: "The wave theorists used nine-year averages of shifting tides to build up a rhythmic, uniform wave. Very arbitrary, with no empirical foundation."

A stockbrokermouse hinted at a more sinister reason why many backed the idea of a coming Great Wave: "They just want to scare us into government controls, central planning. Very transparent and shallow—no pun intended."

There was some bobbing of heads in agreement, but the Chairmouse was not without his supporters. One of these, a species of kondratieffmouse, rose to his defense:

"The whole point is that we've been going up for 25 years. Now we are vulnerable to a K-wave—a wall of water that could come crashing down and not recede for 25 years."

Once again groans filled the room. Squeaked one tremulous voice: "We'll all be drowned like . . . like . . . rats."

The kondratieffmouse hastened to bolster his position. Waves, he solemnly insisted, occur with predictably regular periodicity. "Time may be running out, as you can see in this highly classified diagram (see above) tracing wave behavior back to the year 1800."

The diagram seemed to lend some credence to the long-wave theory. Supporters recalled that the mountain goats abroad, at the pres-

tigious BIS (Banque for Infrangible Stilton), had warned in 1978 that the K-wave might soon inundate Mouseville and spread to other places as well. True, that prediction was more than two years old and still no big wave had washed over Mouseville. But a prudent mouse did not quickly dismiss a pronouncement from the BIS. Besides, one should not expect a precise timetable for disaster: waves, after all, don't swell and recede like clockwork. Even the kondratieffmice were quick to admit that a 50-year wave cycle might be delayed a bit.

Most in the room, however, took scant comfort from any suggestions that disaster might be postponed. A hush fell over the room as the members contemplated what seemed a precarious future. There was no denying that, over many decades, waves had built up and then had come tumbling down. Would history repeat itself?

Assurances from the wisemouse

All eyes turned expectantly toward the Chairmouse. He would see a way out. Sure enough, the Chairmouse stepped forward and intoned: "For guidance in these troubled times I call on our venerable senior adviser."

There was a swivelling of chairs toward the back of the room. A thin, stooped figure rose and bowed slightly from the waist. It was the astute wisemouse, adviser to Chairmice, confidant of nabobmice, held in awe by even the mighty sheikcamels. He squeaked softly:

"My friends, be not unduly alarmed. There is a flaw in thinking that an immutable law of nature ordains a periodic drenching. The Great Wave is the product of a bygone era. In the old days we had a classic cheese standard, which limited creation of money. Wartime inflation exhausted the money-creating power; after each war, money growth had to be held down rigidly. Waves in the past came crashing down after wartime peaks. This time, with no rigid cheese standard, the waves have not followed—and need not—the prescribed path of the kondratieffmice. Past is not necessarily prologue."

As one the councilormice rose, their paws beating in exultation. The wisemouse had put his paw on a significant difference between "then" and "now." The applause tapered off, however, as the wisemouse signaled that he was not finished:

"Gentlemice, I hasten to add that we should not assume that we could not bring on severe wave problems. Above all, if we are to keep the flood away we *must* sharply reduce the inflation that is battering our dams and dikes. Moreover, I fully expect that we shall be buffeted by choppy seas that will undoubtedly mean water in the basement on occasion. But chances of a cataclysmic flood must be rated as rather low. Over the long span of Mouseville's history it is the optimice that have been nearer the mark than the doomstermice."

Sighs of relief could be heard in the council chamber. The wisemouse's cool appraisal had a calming effect. Reassured, the councilormice began to file out.

The Chairmouse blushed becomingly as he received the congratulations of the departing members for a well-run meeting. Stepping out into the frosty air he mused to no one in particular: "Guess I'll go straight home . . . on second thought, maybe I should stop at the store . . . buy a pair of water wings . . . just in case."

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Entering 1980

A final tally on Christmas-period sales isn't available as this is being written, but it appears from partial data that merchants (other than auto dealers) enjoyed reasonably good sales in most parts of the country in December—despite the heavy debt burden of consumers and despite the squeeze on income imposed by inflation. (The December sales performance was somewhat ambiguous, however, because higher volume was based to an unusual degree on pre-Christmas clearance sales.)

Thus, while the specter of recession is still very much present, weakening tendencies do not yet seem to be cumulating rapidly. That impression has been reinforced by other data that have become available during the past month—most particularly by information showing the continuation of rather broadly diffused employment gains in November and by government survey data pointing to the likelihood of a continuing rise in "real" (inflation-adjusted) capital spending during the first half of 1980.

While a case can be made that aggregate activity has begun to slip, there is no indication of a replication of the marked erosion that occurred in the winter of 1974-75. It may well be, indeed, that for the fourth quarter of 1979 "real" GNP will show little—and possibly no—decline. The most clear-cut weaknesses in the economy at present are centered in housing and in sales of domestically produced cars. It would obviously be a mistake to minimize the downside potential of either of these major sectors of the economy. Continuing uncertainty about the availability and cost of gasoline could well generate still further softening in the auto market—and bring new auto production scalebacks and layoffs. And in the case of housing, evidence is multiplying that a downturn is in fact

decisively under way. That evidence includes: a sharp retreat in both starts and permits in November, featured by especially significant year-over-year declines in the single-family segment of the market; markedly less buoyant sales conditions for both new and used homes; and indications that the heretofore rapid climb in housing prices is slowing.

Signs of mounting problems for the home-building industry recently have brought a flurry of government measures to improve mortgage availability. Among these: modifications of federal rules to increase the ability of depository institutions to compete for funds in the domestic and, in the case of savings and loan associations, the Euro-dollar markets; and Congressional action to suspend mortgage interest-rate ceilings imposed by the states.

While such actions undoubtedly will be helpful, trouble in housing seems to reflect more than lessened mortgage-money availability. There are rather clear signs actually that some would-be home buyers are hesitating at the prospect of having to commit themselves to long-term mortgage contracts at rates in the 12% to 14% range. Indeed, some West Coast mortgage lenders—citing weakening borrower demands—have begun to nudge mortgage rates downward.

If, as seems probable, housing is now weakening decisively, it then becomes important to bear in mind that it is not housing alone that one needs to focus on to gauge the potential depressant effect on aggregate business activity. Rather, reverberations could work back through personal consumption expenditures generally, especially because of the extent to which Americans in the last several years have been borrowing against their accumulated—and rapidly increasing—home-ownership equity to finance a wide range of consumer-goods purchases. In a weakening housing market, that supplement to income can be expected to diminish rapidly, something that emphasizes the riskiness of assuming that only a moderate recession lies ahead.

Actually, the greatest downside risk now present in the economy probably resides, somewhat ironically, in the fact that consumption expenditures have been as strong as they have been. Sluggish during most of the early part of 1979, they have spurted strongly since late summer (with retail sales up at an average 20% annual rate in the four months ended November). That buying spree could not have been anticipated on the basis of either the debt or the income status of households. What consumers have done—in part apparently because of diminished confidence that inflation will be effectively controlled—is to shift toward a more aggressive buying stance, accommodating their enlarged purchases by a further scaledown of personal saving.

Slumping saving rate

New monthly estimates by government show the personal saving rate gravitating toward the 3% level in the autumn period, down significantly from its over-5% reading in the first half of 1979 and down markedly from the longer-term norm of 6%. This situation highlights the vulnerability of retail activity. Anything which would prompt households to revert to more normal saving patterns—say, concern about job security as a result of a climb in the unemployment rate this winter (an odds-on probability)—could change consumer spending inclinations both drastically and quickly. The economic forecaster certainly has to wrestle with that as a possibility, but regrettably cannot dismiss entirely the radically different alternative possibility that inflation apprehension and attempts by

households to maintain living standards will drive the saving rate even lower than it already is. More than any other single factor, these extraordinarily open-ended possibilities for consumption bedevil any attempt to call a general business-cycle turn with precision—just, indeed, as the volatility of consumption repeatedly confused would-be forecasters throughout 1979.

Adding importantly to turn-of-the-year uncertainty is the unsettled manner in which OPEC's Caracas meeting ended—without, that is, the establishment of an agreed upon common price. Oil-price "leap-frogging"—of the kind that transformed December 1978's 15% increase into an 80% rise (fourth quarter 1979 over a year earlier)—is now obviously a continuing possibility. And that, of course, is a chilling consideration, since it was 1979's repeated hiking of oil prices, more than anything else, that caused price, interest-rate, and current-account developments to become so adverse and so wide of projections.

Circumstances, to be sure, could be markedly different this year—partly because, on a worldwide basis, oil inventories have been built up substantially in recent months and partly because world industrial activity apparently is in the process of slowing. Evolving market conditions may thus prove inimical to significant further oil price increases. But what conditions will in fact prevail in oil markets (whether those of mini-glut or supply strain) will not be known until the overlay of political troubles in the Middle East is clarified. And there can be no confidence, unfortunately, that such clarification will come soon.

Credit Markets in the Year Ahead

IF the economy experiences the moderate recession this year that is commonly expected, private credit demands will unquestionably ease while those of the Federal government will tend to rise. The net effect should be a fairly significant decline in total credit demands, accompanied by some reduction in interest rates, both short- and long-term.

The tables on pages four and five provide estimates of what could be expected to happen to credit flows this year both in the aggregate and market by market if in fact a moderate recession occurs. In the context of a softening economy—with "real" GNP down by, say, 1% year over year—it seems reasonable to project a decline of 10% or more in total credit demands in 1980, from last year's almost $500 billion to something in the vicinity of $440 billion. Slackening credit usage is likely in all sectors of the private economy, with easing, however, most pronounced in the case of business demand for short-term credit and household use of installment and mortgage credit.

The amount by which business borrowing declines will depend critically on how speedily a weakening economy affects corporate profits versus how speedily business investment is affected. It would not be surprising to see recession hit corporate profits relatively quickly, with business unable to scale back capital outlays commensurately. That could keep the gap between business investment and retained earnings quite high in the first half of 1980. Indeed, although business borrowing from commercial banks was all but flat in last year's fourth quarter, following rapid growth earlier in 1979, there

The Demand for Credit

(Billions of dollars)

	1974	*1975*	*1976*	*1977*	*1978*	*1979**	*1980**
Federal government issues	12.0	85.8	69.1	57.6	55.1	39.0	60.0
Federal agency issues	22.2	12.3	19.0	26.7	40.1	50.0	40.0
State & local government issues	17.2	16.3	17.7	23.9	26.7	24.0	24.0
Corporate bonds	21.8	30.2	28.6	31.0	27.6	30.0	40.0
Corporate stocks	5.0	10.6	12.6	4.7	5.2	4.0	6.0
Foreign securities	1.9	6.4	8.9	5.5	3.5	3.0	5.0
Mortgages	60.5	57.2	87.1	134.0	149.0	160.0	135.0
Other business credit	62.9	−13.0	18.7	55.1	80.7	110.0	75.0
Consumer credit	9.9	9.7	25.6	40.6	50.6	45.0	30.0
All other credit	14.6	12.2	17.8	18.6	41.8	30.0	25.0
Total credit demand	228.0	227.7	305.1	397.7	480.3	495.0	440.0

*Estimated. Due to rounding, components may not add to totals.

is a distinct chance of some reacceleration in the next several months.

The 1980 increase in short-term business indebtedness—shown in the table as "other business credit"*—is apt to advance only by $75 billion, a bit less than in 1978 but significantly lower than in 1979. Such an easing in the growth of short-term business borrowing would, of course, be far more modest than that which occurred in 1975 when corporations actually paid down $13 billion in short-dated liabilities. The narrowing in the corporate financing "gap" this year ought to be much smaller than the drop between 1974 and 1975 if economic weakening is in fact much less steep this time. Part of the reason, of course, for the expectation of a shallower decline in business activity is that corporations during the last several years have been notably cautious in avoiding the speculative overbuilding of structures, equipment, and inventories that characterized the 1970-74 cyclical expansion. Also, it is well to remember that credit demand is related to activity that must be financed at current prices. An inflation rate expected to remain in or close to double digits argues against a drastic curtailment in the dollar total of business borrowing.

Business demand for short-term credit is apt to be replaced, to some extent, by very active issuance of corporate bonds. For 1980, net corporate bond floatations could easily total a record $40 billion. Corporations presumably will be endeavoring to improve corporate liquidity positions which have eroded recently under a flood of short-term borrowing.

Analysis of U.S. government financing needs for the coming year has, of course, been made much more difficult by uncertainties that surround the timing and magnitude of energy, tax reform, and fiscal-stimulus legislation. As of this writing, for example, a "windfall profits" tax beginning sometime around the second quarter appears to be a sure bet, although it will probably build up slowly and have only a minor effect on

*Including bank and finance company loans to business, open-market paper, and net trade credit—largely short-term borrowing.

Where the Money Might Come From

(Billions of dollars)

	1974	*1975*	*1976*	*1977*	*1978*	*1979**	*1980**
Commercial banks	66.6	29.4	59.7	87.7	128.8	140.0	100.0
Savings institutions	24.4	53.7	70.9	82.4	76.0	68.0	75.0
Insurance and pension sector	32.4	43.3	50.7	59.9	65.5	77.0	85.0
Other finance	7.9	5.6	21.3	33.6	34.4	60.0	40.0
Nonfinancial corporations	11.0	12.0	13.7	4.2	7.5	12.0	10.0
Government, including Federal Reserve	36.2	45.0	49.0	55.3	74.1	80.0	75.0
Foreign investors	11.7	10.8	18.0	42.1	40.1	4.0	10.0
Individuals and others	37.9	27.9	21.7	32.7	54.3	54.0	45.0
Total credit supply	228.0	227.7	305.1	397.7	480.3	495.0	440.0

*Estimated. Due to rounding, components may not add to totals.

Treasury revenues in 1980. Most importantly, though, the economic recession projected for this year will have a heavy impact on Treasury finance: government spending for programs such as unemployment insurance, for example, will rise and revenues will shrink as profits and income growth slows. As a result, the budget deficit will widen this year (chart on page 6). However, that should cause no financing congestion in markets since private credit demands will be receding. Treasury borrowing requirements will expand to an estimated $60 billion, significantly above 1979 and the largest borrowing total in four years. Nevertheless, Treasury money needs will remain far below the huge $85.8 billion of 1975, when a tremendous dose of fiscal stimulus was necessary to brake the economy's steepest postwar slide.

Federal agency borrowing is expected to shrink somewhat from last year's record–estimated at $50 billion–to around $40 billion, the same as in 1978. Although the Federal Farm Credit System will remain active in the credit markets to finance agricultural sector activities that continue to be squeezed by inflation, there is likely to be some tailing off in the borrowing needs of the Federal Home Loan Banks and other housing related agencies as savings inflows to private institutions improve during 1980.

State and local governments in 1980 are expected to borrow about the same amount as last year. While it is true that economic conditions are expected to cause a shrinkage in the budget surpluses that these governments have shown in recent years, thus increasing financing requirements somewhat, there is likely to be a considerable cutback in housing revenue bonds. Also, as a result of taxpayer resistance, there has been a clear trend among these governments away from ambitious new construction projects–a further constraint on new financings this year.

Net new mortgage formation is likely to be down from last year's record pace. The demand for mortgage credit has slackened recently in response to sharply escalating mortgage rates, and, simultaneously, mortgage money availability has dwindled as thrift institutions have cut back on lending as a result of a marked slowing in deposit flows. And these savings inflows are unlikely to regain any real vigor until open-market

interest rates come down significantly, a process that at a minimum will take several months to unfold. Even once that happens, recessionary conditions may curb people's inclinations to move to different–usually larger and more expensive–quarters. Housing starts could readily fall about 20% this year from 1979. That prospect points to a net increase in mortgage debt in 1980 of approximately $135 billion, down from a record $160 billion last year.

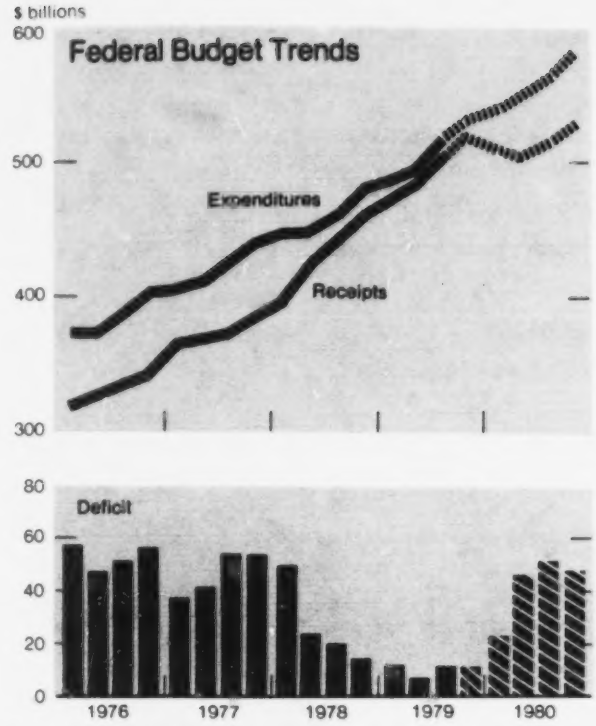
Finally, there's the consumer's need for credit to pay for purchases all across the board. Last year, purchases were generally well maintained and for the year as a whole consumer credit is estimated to have risen by $45 billion, an annual increase second only to 1978. Late in the year, however, the auto market weakened significantly, and lessened interest by U.S. consumers in other major durables would hardly be surprising as 1980 unfolds in view of the weakening that has occurred in household financial conditions. Real wages have been declining for many months and debt loads have risen sharply–factors which point to major balance sheet corrections on the part of the household sector.

For this year, personal consumption expenditures on durable goods–even measured in current prices–seem likely to drop for the first time since 1974. In particular, the moderate recession hypothesis involves a decline to under 9 million units in new-car sales–down from 10.6 million last year and 11.3 million in 1978. Thus, the torrid pace of consumer-credit expansion over the past three years is expected to slow dramatically this year.

Sources of funds

So much for the demand for credit. But where will the money come from? Monetary policy, despite the October 6 shift toward greater emphasis on fighting inflation, presumably will evolve in an accommodative direction if recession in fact emerges. Commercial banks therefore should have the capacity to respond fairly flexibly to customer needs, and it seems reasonable to expect that commercial banks will in 1980, as in 1979, be the nation's largest supplier of funds. To be sure, commercial-bank credit extension will not match last year's record $140 billion but it should approximate $100 billion. This would represent about an 8½% increase in the outstanding volume of bank credit, compared with more than 13½% in each of the past two years.

Savings institutions, as indicated earlier, are experiencing some major disruptions in the supply of savings deposits. While this may continue for some months to come, savings flows should strengthen in cyclical fashion later this year, as



NOTE: Dashed lines and bars are estimates. All plottings are quarterly, seasonally adjusted annual rates on a national income accounts basis.

market interest rates retrace some of their 1979 rise. Savings institutions can reasonably be expected to supply about $75 billion to credit markets in 1980, up from an estimated $68 billion in 1979 and about the same volume as in 1978. As usual, mortgage markets will be the main outlet for these funds.

The insurance and pension sector, whose inflows are largely contractual in nature, can be expected to continue on its recent upward growth path as a source of funds this year. Within this sector, the bulk of life insurance company investments will once again be directed toward corporate bonds and, to a lesser extent, mortgages. Private noninsured pension funds will probably show an increased appetite for equity investments.

Summing up

A major uncertainty overhanging the credit markets in any year is the volume of funds to be supplied by foreign investors. This figure is almost impossible to project since, in any year, it results from a combination of factors such as international interest rate differentials, balance-of-payments developments, and the degree of intervention by central banks in foreign exchange markets. In recent years, foreign-source funds have ranged from a high of $42.1 billion in 1977 to an estimated low of $4 billion last year. Recognizing these imponderables, it is estimated that foreign investors will increase their supplying of funds this year to $10 billion, largely reflecting a widening in the U.S. current-account deficit.

It is obvious—particularly in view of overhanging uncertainties in the Middle East—that credit market flows over the course of the year could turn out in ways very different from those presented here. Troubles in Iran could escalate, with important effects on U.S. defense spending. And worldwide oil-supply and oil-price developments in the coming year could severely affect economic activity both in the U.S. and elsewhere. Indeed, even without a major disturbance from the Middle East, economic events could unfold very differently in 1980 than is anticipated by the moderate-recession hypothesis. Given, for instance, the present abnormally low personal-saving rate, the potential is certainly present for a more pronounced curtailment of consumer spending in the months ahead than is generally anticipated.

Nevertheless, until there is some clarification of the unusual uncertainties now prevailing, the moderate-recession forecast is at least as reasonable as any competing scenario. If the credit-flow estimates that go along with a mild downturn are anywhere near the mark, the economy should now be experiencing peak levels of interest rates on a cyclical basis and a declining tendency for rates should not be too far distant. It is particularly encouraging that the purchase of direct market investments by "individuals and others"—often regarded as a reliable barometer of interest rate pressures—promises to shrink in 1980 for the first time in four years.

Toward a More Effective Export Policy

DESPITE a significant increase in exports, the United States ran a merchandise-trade deficit in 1979 of some $24 billion. This was an improvement over the unprecedented deficits of the previous two years—$28.5 billion in 1978 and $26.5 billion in 1977. But such large red-ink figures for the third year in a row—together with the sharp increase in the U.S. oil-import bill expected this year—underscore the need, stressed by President Carter, for business and the federal government to "place a higher priority on exports."

Awareness of that need is growing, and a search for an effective national export policy is under way, as are attempts in various business forums to raise the export consciousness of U.S. companies. As is widely recognized, however, the U.S. faces a major challenge in achieving a rapid breakthrough to a higher level of export business.

U.S. exports benefited in 1979 from increased economic activity abroad as well as the dollar's earlier depreciation and ran some 27% higher at a seasonally adjusted annual rate during the first ten months than in the same period in 1978. That was itself a year of significant export improvement over the two preceding years. As a result, a precipitous decline between late 1975 and early 1978 in the U.S. share of world exports of manufactured goods—a barometer of competitive strength—has been reversed. By the first quarter of 1979 (the latest period for which data are available) the U. S. share had recovered to 17.5% from an all-time low of 16.2% in the first quarter of 1978. The improved reading, however, was still moderately below market share held by this country earlier in the decade.

A basic obstacle to attainment of a higher level of export business is that U.S. industry—with the world's largest and richest domestic market—traditionally has shown much less zeal for exports than its counterparts in other industrial countries. While many U.S. firms obviously work hard and successfully at selling abroad, just 200 companies are estimated to account for about four fifths of U.S. exports of manufactured goods. Moreover, in recent years U.S. industry's once commanding technological leads have waned. The emergence of the European airbus as the first major competition for U.S. commercial aircraft in the jet age is but one striking example. Too, U.S. exporters suffer a competitive disadvantage vis-à-vis European exporters because the rules of the General Agreement on Tariffs and Trade permit rebates of value added taxes on exports but not of corporate income or excise taxes on which the U.S. relies. European producers thus have a 12%-to-20% tax advantage over American exporters.

Those firms making vigorous efforts to compete in foreign markets, moreover, in numerous instances have run into obstacles arising from U.S. government policies. For national-security reasons the U.S. exercises tighter controls on exports of technologically advanced goods to the Soviet bloc than do other nations, and it also uses controls as an instrument of foreign policy—blocking exports, for instance, to express displeasure with the behavior of another country. In many cases, such actions have resulted in potential U.S. sales being captured by foreign competitors. As an example, President Carter banned the sale of a Sperry Univac computer to the Soviet news agency, Tass, in July 1978—tying the action to Soviet trials of dissidents. Although the Administration approved a new license application eight months later, by that

time Tass had arranged to buy a computer from a French firm.

In a world in which government-assisted export financing has played a growing role in national efforts to boost exports, the U.S. has lagged in providing such assistance to U.S. firms —though this has changed in the past year or so as the Export-Import Bank has been playing a more active role. Despite such efforts, however, U.S. exporters remain at a competitive disadvantage in selling to the Soviet Union and Eastern Europe because Congress has conditioned Eximbank credits to communist nations on their assurances of free emigration for their people. Eximbank has extended no credits to the Soviet Union since that condition was imposed in 1974. Eximbank is also severely limited by law in financing sales to South Africa, and on State Department advice frequently has held up or denied credits to other countries because of their human-rights policies. Human-rights considerations, of course, are not without appeal, but there is a cost involved in this country's unilateral attempts to influence other countries policies in this respect.

In other areas of national policy, antitrust regulations long have deterred U.S. firms from forming consortia to bid on projects abroad as their competitors do freely. More recently, concerns about the Arab boycott of Israel have brought new unilateral restrictions on U.S. firms' activities, creating much uncertainty among exporters as to what is permissible. Similar uncertainties have arisen from other unilateral legislation barring U.S. firms from making payments to foreign officials to obtain business.

Another area of concern to exporters has been that, with government responsibilities for trade matters scattered among numerous agencies, the executive branch has not been organized to conduct a coherent trade strategy. In a potentially important step aimed at remedying that deficiency, the Administration plans to centralize trade policy development and coordination in the White House Office of the U.S. Trade Representative. Some critics contend that the reorganization plan falls short because policy and operational responsibilities—the latter centered in the Commerce Department—remain divided. But on paper, at least, with the policy focus in the White House, exporting should have a higher profile in government councils than it has had heretofore.

Clarifying the controls

Meanwhile, in extending the export-controls program last September, Congress made some changes of potential assistance to U.S. exporters. Important provisions of the Export Administration Act of 1979 are intended to streamline licensing procedures, reduce the number of items controlled for national-security reasons, and bring more predictability to the controls process. Another key innovation is to require a greater measure of public accountability when export controls are used for foreign-policy reasons. It is too early to see actual changes in the administration of export controls or their use for foreign-policy purposes, but many business firms express hope that the new law will bring improvement over previous practices.

After a prolonged interagency debate about whether or not to clarify ambiguities in the law prohibiting U.S. firms from making payments to foreign officials to win contracts, the Justice Department in November announced a procedure for reviewing contemplated transactions. This may help relieve the uncertainties firms face in this area, though it does not eliminate them. The SEC, which shares responsibility for enforcing the act, has declined to adopt simi-

lar guidance and is not bound by Justice Department decisions. Thus, the SEC could initiate a civil action against a firm even after it has received assurances from the Justice Department that a transaction does not violate the law's criminal provisions. Some Senators reportedly plan an effort this year to soften the law; a principal aim, backed by business, is to eliminate criminal penalties for violations.

Congress may also clarify what U.S. exporters may do under antitrust laws. The Webb-Pomerene Act of 1918 permitted American companies to form export associations with immunity from antitrust laws—the intent being to enable U.S. exporters to compete more effectively with foreign cartels. Disputes about the extent of antitrust immunity have inhibited use of this vehicle. In recent years Webb-Pomerene associations have accounted for less than 2% of U.S. exports, compared with about 19% at their high in the 1930s.

With fresh support for such associations gathering in Congress, it is possible that this year will see action on revisions of the Webb-Pomerene Act. Major features of a bill that is attracting much attention would create a preclearance procedure and would for the first time make service companies—such as construction and consulting firms—eligible to form export associations.

Eximbank's new role

The most dramatic development in export policy has been the Export-Import Bank's new activism, noted earlier, in supporting foreign sales. As recently as 1977 the bank extended credits of only $700 million, well below its lending authority for that fiscal year, but in fiscal 1979 it used its full $3.6-billion authority.

Under an agreement among industrial countries, interest rates on loans by government financing agencies are not to be below 7¼%, but that agreement has been breached as export-financing competition has become increasingly fierce in recent years—with France, Britain, and Japan particularly aggressive in offering cut-rate terms. For a new airport in Indonesia, as an extreme example, France offered 30-year financing at 3%. The U.S. has opposed use of such aid-type concessional credits for export financing, and in negotiations early last year the Administration tried to convince other countries to reduce the subsidy elements in trade finance. When that effort failed, the Administration decided that—wasteful as such subsidies are—the U.S. must face the issue and itself be more aggressive in export financing. Thus Eximbank has lowered its rate schedule—normally a range of 7¾% to 8¾%—in selective cases to match the bargain-basement terms of other nations. For example, it helped a U.S. firm win a telecommunications contract in Cyprus by matching a French credit—bringing its interest charge down to 6% and making certain other alterations in its usual terms. But there is a limit to what Exim can do and stay self-supporting as the law requires.

Eximbank carried over some $500 million of 1979 requests for credits for a South Korean nuclear project into fiscal 1980. For this year the Administration raised the bank's lending authority, which is treated as part of the unified budget, to $4.1 billion but did not want to go higher in view of over-all budgetary constraints. This $500-million raise, however, provides no real increase in the bank's lending authority this year since it just about matches the inflation rate and is in any event absorbed by the Korean-project carryover. The House adopted the Administration figure, but the Senate, prompted by business groups, raised it to $6.0 billion. The

difference has not been reconciled and for the time being Exim is operating under a continuing resolution at the 1979 level. The Administration's $4.1-billion request does not include provision for credits to China—something contemplated in connection with the U.S.-China trade agreement submitted to Congress last fall.

Goals and conflicts

Discussion of a more effective national export policy, if not as yet productive of dramatic initiatives, has been constructive. Washington seems to be awakening to the conflicts between some of the government's nontrade objectives and the new goal of expanded exports. Those conflicts obviously are not easy to resolve, and noncommercial considerations will continue to play a role in trade policy.

National security of course demands this, and there will be other compelling reasons as well for using trade as a policy instrument, as is pointed up by the Iranian situation. But if the government wants to promote a vigorous foreign-sales drive, officials need to recognize that retention of one-sided burdens on U.S. exporters will continue to detract from their performance.

A New Portrait of America

ON March 28, every household in America will find in its mailbox a lengthy list of rather personal questions—each of which must, by law, be answered. That questionnaire will launch what seems sure to be the biggest participatory event in peacetime U.S. history: the 1980 census.

The head count, which will require an added temporary work force of 270,000 and cost close to a billion dollars, will cover all 50 states, Puerto Rico, the Virgin Islands, Guam, American Samoa, and the Trust Territories of the Pacific Islands. Data will be compiled for 3,200 counties; 20,000 villages, towns, and cities; and 2,500,000 city blocks.

With the exception of foreign diplomats and tourists, the aim is to enumerate everyone—including those in hospitals, in old-age homes, in prisons, on naval ships at sea. Inevitably, however, this census, like all the others, will fall short.*

Several billion items of information will pour in from the public, enough to fill some 300,000 pages of statistics. Those pages will reveal dramatic changes in American family life, income, housing costs, energy use, population distribution and will importantly affect Congressional representation.**

Census questions will seek basic information about people (age, sex, occupation, income, and the like) and about subjects such as housing, personal transportation, and energy use. Most people will be asked to answer the short form—19 questions. About one in five households, chosen randomly, will receive the long form, which contains an additional 46 questions. (As might be expected, the first census was much different—box on page 13.)

Roughly 90% of the households will take their own census—that is, they will simply fill in the questionnaire and mail it back. (If they fail to do this, however, a census taker will come calling for the information.) The remaining 10% of households will be asked to hold the questionnaires until census takers pick them up.

Queries and confidentiality

Federal law (Title 13 of the U.S. Code) requires everyone to answer the census; failure to do so can mean a fine of $100. That same law also assures that every person's answers are kept confidential. The only people who can see an individual's replies are census employees, who are sworn to secrecy under threat of a $5,000 fine and a five-year prison term. No other federal agency nor, for that matter, even the President can see individual census answers.*

The census form does not ask for Social Security numbers. In transferring data from the questionnaires, no names or addresses will be transmitted to the computers. Several years after the census, the original census forms will be shipped in sealed boxcars to sites where they will be shredded, dissolved in acid, and recycled into paper pulp.

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*The first census, in 1790, was thought to have undercounted by 200,000 people, or 5%. In the most recent (1970) census, the Census Bureau estimated the undercount at 2.5% nationwide. That meant that 5 million persons were "missed."

**In late December a lawsuit was filed against the Census Bureau challenging the inclusion of illegal aliens in the headcount. The suit asserts that the plan to include them would dilute the political representation of citizens and lawful immigrants and give an undue number of Congressional seats to such states as New York and California, which have large concentrations of illegal immigrants.

*For example, the Immigration Service cannot get hold of census data to track down illegal aliens; neither can the IRS get census replies to match against tax returns.

THE FIRST CENSUS

THIS year's decennial census will be the nation's twentieth. The head count over the centuries, thus, has moved from quill pens to computers. But its roots remain unchanged: the U.S. Constitution.

When the delegates to the Constitutional Convention met in 1787, they decided that population distribution should be the basis for direct taxation and for apportionment in the House of Representatives. They approved a Constitutional requirement that every person be counted at least once every decade, starting in 1790.

Congress appointed Secretary of State Thomas Jefferson to direct the first census. Enumerators, under the direction of 17 U.S. marshals, were paid between one-third cent and two cents for every inhabitant they counted in the 16 states and the Southwestern territory.

The first tally asked only five questions: number of free white males 16 years of age or older; number of free white males under 16 years; number of free white females; number of other free persons; and number of slaves.

Census takers posted their work in the public square. Anyone missed was expected to add his or her name to the list. Thomas Jefferson, apparently, was missed; he had to add his name to the list posted in Philadelphia.

The count took eighteen months. It showed a population of just under 4 million.

Confidentiality of the census data put on microfilm is protected for 72 years—or until 2052. In the 50-year history of the modern census-confidentiality law, the Census Bureau has never been charged with releasing information about any individual. The courts have continually upheld the Census Bureau's refusal to release such information.

Why bother?

Censuses over the decades have been called the backbone of the nation's history. They define the population, show what it does, reveal how it lives—right down to the block level.

More than a hundred federal programs, involving spending of some $50 billion, are guided by census results. These range from modest programs to help abused children to billions in grants to states and localities.

New population patterns will require extensive redrawing of district boundaries for the House of Representatives. After reapportionment, a majority of the members of the House are expected to be Southerners or Westerners for the first time in the nation's history. States that are expected to gain representation as a result of the 1980 census: California, Texas, Florida, Utah, Oregon, Tennessee, Washington, Arizona. States expected to lose seats: New York, Ohio, Illinois, Pennsylvania, Michigan, and South Dakota.

American businesses, from local Mom-and-Pop stores to multinational corporations, rely on the census numbers to select plant sites, evaluate product lines, and analyze sales and marketing strategies. For example, in Illinois a real estate firm uses census data to give home buyers a profile of prospective neighborhoods. In Detroit, a pizza parlor chain relies on census population and income patterns to plan new outlets. Transportation planners routinely use the census to map bus routes, subway stops, and places where new and improved highways are needed. In Indianapolis, census data have pinpointed the twenty areas of the city with the

largest number of senior citizens. And in Denver, a young woman recently phoned the Census Bureau to ask how she could find out the number of unmarried men in that city. The Census Bureau said it could supply that information—right down to the neighborhood level.

Census preview

What will the 1980 census show when it is completed in 1981? Hard numbers, obviously, must await the final tally. But, based on regular Census Bureau surveys and samplings, some results can be predicted with reasonable certainty.

Total population on "Census Day"—April 1—is expected to reach 222 million, a gain of 9% since 1970. If the final tally bears that number out, the rate of increase in U.S. population in the 1970s will have been the second lowest in history. The 1940 census showed a record low population growth rate, owing to the effects of the Great Depression.

Housing units in the nation are expected to number 86 million in 1980, up a little over 20% since 1970—about double the rate of population growth. More than half of the questions that will be asked in the 1980 census will focus on the nation's housing stock—its condition, value, energy usage. Census housing data are crucial, of course, to decisions about urban renewal, water and sewer availability, school openings or shutdowns, mortgage assistance programs, mass transportation, and the like.

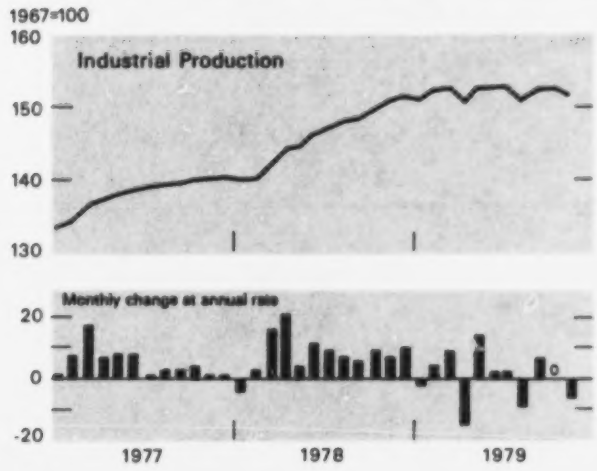
Energy use in homes will get added attention in the upcoming census. Between 1950 and 1975, the number of U.S. households using coal and wood diminished to less than 1% for each fuel. But natural gas use increased from 23% of all homes in 1950 to 57% in 1975. The new census is expected to show wood and coal surging in popularity.

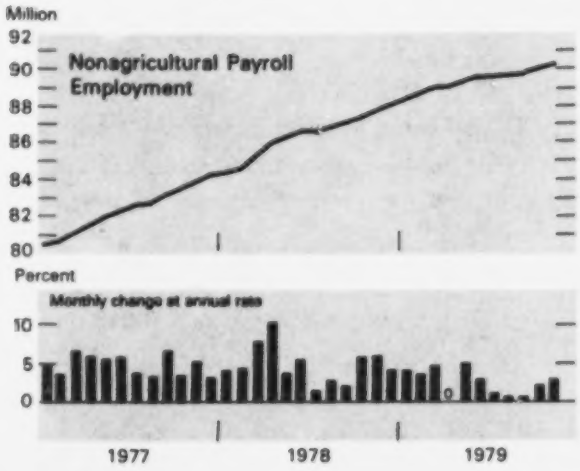
Here are some other trends that are expected to be confirmed by the 1980 census:

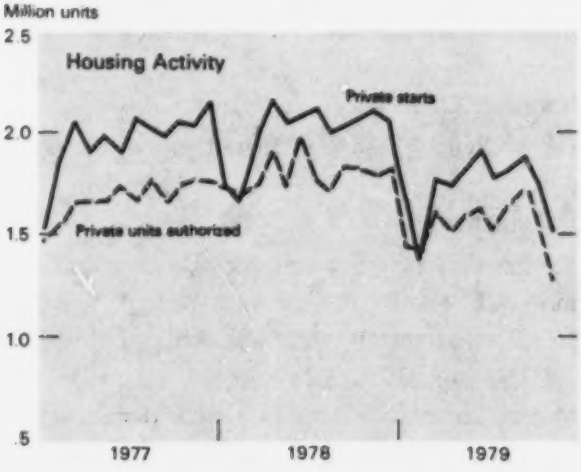
- The number of husbandless women who are heading families has climbed nearly 50% since 1970 to more than 8 million.
- The traditional family household of mother, father, and one or more children now accounts for less than a third of the nation's households, the lowest percentage ever.
- Both husband and wife have earned incomes in about half of the 48 million husband-wife families, a new high.
- In recent years, blacks moving to the South have outnumbered those leaving, reversing a 100-year trend. The new census will determine whether the blacks moving into the South are newcomers or are returning to the South, where they are settling, and what job skills they bring.
- Adjusted for inflation, there was a 34% increase in median family income between 1960 and 1970. The increase between 1970 and 1978 was only 4%. The big drop can be attributed to economic sluggishness, to the increase in the number of families maintained by one parent (who tend to have a lower average income), and to changing age structure and family composition. Census surveys show that, compared with the 1960s, a higher percentage of people are now in their early, rather than mature, earning years.
- Nonmetropolitan areas in the 1970s have been growing faster than metropolitan areas; from the 1940s through the 1960s, metropolitan areas had grown more rapidly.
- The divorce rate has increased most dramatically in the 30-to-44 age bracket, reversing a long-standing trend in which the divorce rate was highest for couples over 45.

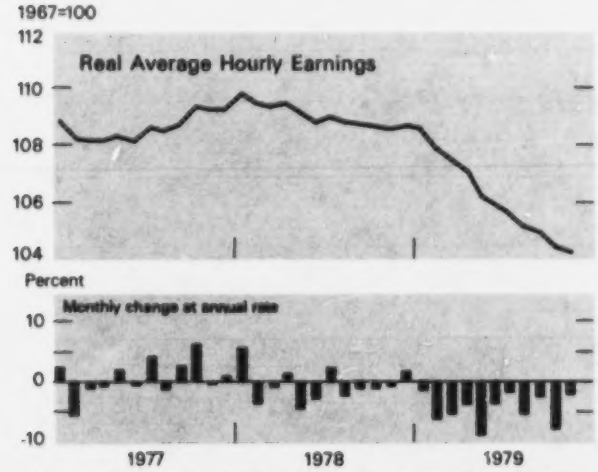
And so it goes, a sample of the myriad measures which will produce a new—and much more complete—statistical portrait of America.

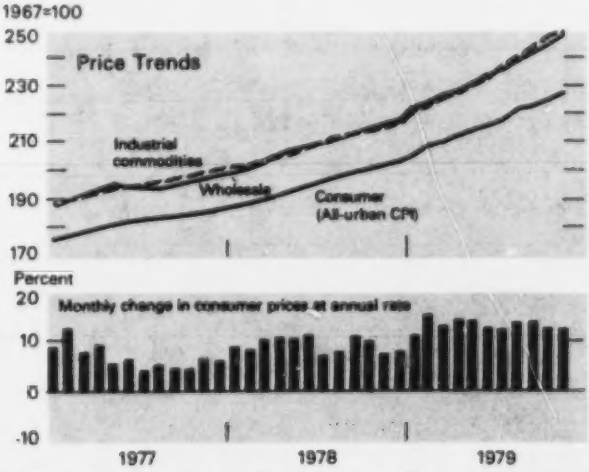
ECONOMIC INDICATORS











NOTE: Latest plotting in each chart is for the month of November. All data are seasonally adjusted. Average hourly earnings are adjusted for overtime hours in manufacturing and for interindustry employment shifts.

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What Next for the Peekaboo Recession?

So far, the economy has stubbornly refused to slide into the recession that analysts have been warning about for more than a year. Indeed, activity actually picked up over the course of 1979, as "real" GNP rose in the second half of the year at an annual rate of almost 2½% after a fractional drop in the first half. Moreover, the economy's continued advance at yearend raises the distinct possibility that overall growth will be sustained in coming months.

The main reason for the economy's staying power has been the American consumer. Even though battered by inflation (higher prices wiped out gains in disposable personal income in the last half), consumers provided a powerful sustaining force by increasing their outlays at an impressive 4½% annual rate during the second half of last year.

To pay for it all, consumers dramatically altered their old habits of thriftiness. The saving rate in the fourth quarter dipped to levels not seen in this country in nearly thirty years. The decision to spend in the face of virulent inflation marked a reversal of old attitudes; in earlier years, consumers tended to reduce spending and increase saving when inflation worsened (story on page 11).

Whether the new attitudes toward spending/saving will persist is crucial to the pace of business activity in the months just ahead. Conceivably, consumers could decide to stick with the current low saving rate—or, even, to reduce it further. For many, inflation at today's feverish rate is a strong inducement to buy before prices go even higher. At the same time, putting money into financial assets can lose its appeal as inflation erodes values.

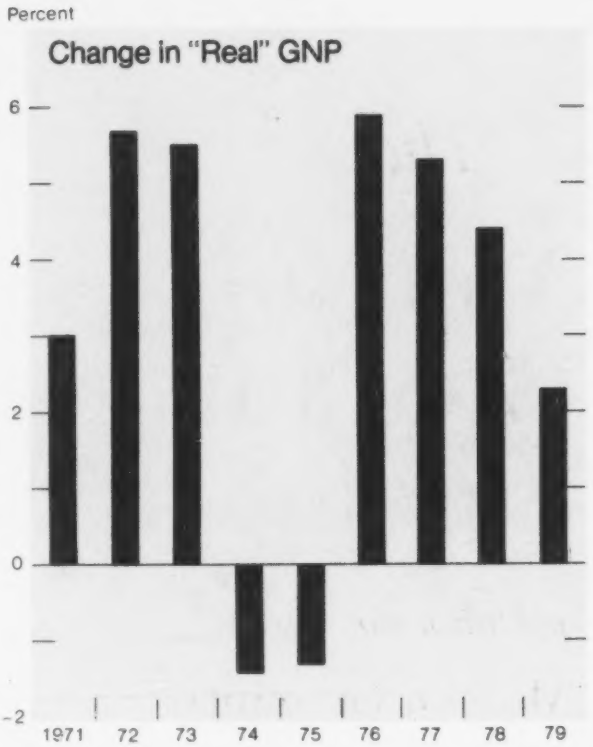
Against such a background in 1979, acquisition of financial assets by households tended to slow. And, since the turnover of existing houses was relatively high for much of the year, the opportunity remained for many to finance purchases of consumer goods with the capital gains from home sales. However, tapping home-owner equity as a source of funds to support spending levels is not going to be so easy in the current setting. The earlier boom in the housing market has ended. Sales of new and existing homes are down in the past several months—and so, too, are housing prices. There has been a significant drop, as well, in housing starts.

The changed picture in housing, thus, seems sure to mean less support for consumers' continued ability to borrow to finance their spending. That, in turn, suggests that the weakening in housing activity that is now developing could have a larger than normal impact on consumer buying generally. The peekaboo recession, finally, should stand still long enough to be counted.

Defense stimulus

Or will it? There are no sure bets because of a new ingredient in the picture: the President's decision to enhance this nation's military capabilities over the next five years. While the broad outlines of the program are evident (a 5% annual rise in real terms in budget authority for defense and a 4% rise in actual outlays), little is known about specifics. Will the decision be to build nuclear aircraft carriers, or the B-1 bomber, or to stick with the volunteer army, or go to the draft? Such choices are pertinent to any assessment of the short-run impact of enlarged defense outlays (story on page 6).

Timing is very important. A decision, for example, quickly to raise the level of the armed



forces would mean immediate orders for uniforms, equipment, a bulge in payrolls—in short, repercussions throughout the economy. Hardware decisions, on the other hand, would require long lead times. The direct effects, thus, would be slow in coming and most likely would not be felt until late in the year at the earliest. It should be remembered, however, that even though hardware orders undoubtedly will take many months or even years to fill, businessmen may decide that enlarged military orders will require expanded capacity. That could produce a firming of capital outlays. Sustained strength in investment activity might well offset, at least in part, any consumer-sector weakness that develops in coming months. In that case, any recession might well be even milder than generally expected and, conceivably, might be no more than a "rolling readjustment."

Meanwhile, economic activity, over all, continues to display surprising stamina. The rise

of real GNP at a 1.4% annual rate in the fourth quarter stands in sharp contrast to the widely held expectation just a few months ago that the fourth quarter would herald the onset of recession. Admittedly, for the quarter as a whole strength was not broadly based. Nondurable consumption together with a surge of federal government purchases (due in large part to special factors) provided most of the support for aggregate activity. But neither was weakness broadly based; indeed, evidence of recession remains confined largely to housing activity and auto buying.

Significantly, economic activity progressively improved toward the end of the fourth quarter (table on this page). Indeed, given the momentum at the end of the year, a first-quarter decline in real output would require a rather precipitous fall-off of aggregate economic activity in January and February. The possibility of such a development cannot, of course, be dismissed out of hand. However, the unseasonably mild weather so far this year—in sharp contrast to the severity of recent winters—should be counted as a potentially positive force in the economy's first-quarter performance, especially in the construction area. To the extent that seasonal-adjustment techniques have overcompensated for the weather-related contractions of the last three winters, even a "normal" winter—by long-term historical standards—could look quite good by comparison. Moreover, while automotive demands remained fairly weak through the first 20 days of January, the leveling out in sales, after an earlier plunge, suggests that such sales may now be close to "bottoming out."

Capital spending—quite aside from any new stimulus from the defense build-up—is moving along at a respectable pace (box on page 4). Both orders and survey data suggest that sustained support from business investment is a strong likelihood in the early part of this year. Finally, the payroll employment figures for January indicate that over-all economic activity was maintained at a high level, despite a rise in the unemployment rate.

Thus, while recent strength does not guarantee positive growth in the first quarter, there seems to be no compelling reason to expect the recession to emerge with sudden clarity in the current quarter.

Recent Economic Indicators

	Percent Change		
	Oct.	*Nov.*	*Dec.*
Employment (Nonfarm payrolls)	0.2	0.1	0.2
Industrial production	−0.1	−0.3	0.3
Personal income	1.0	1.1	1.1
Retail sales	−1.7	0.7	1.1
Shipments (Nondefense capital goods)	0.4	−2.5	2.9
Construction (Private)	2.2	0.0	1.5

Financial markets

As evidence of economic staying power persisted, the market for fixed-income securities reacted negatively in January. The combination of greater-than-expected real economic growth and continuing double-digit inflation conspired with gyrating prices for precious metals to drive interest rates on long-term government and corporate bonds above their November peaks. (The government yield curve in late January was virtually flat at 11% for all maturities from 3 to 30 years.) The outlook for long-term interest rates was further worsened by the prospect of significantly greater defense spending and a larger government deficit. While short-term yields remained well below the autumn highs

BUOYANCY IN CAPITAL SPENDING

CAPITAL spending almost surely is stronger than fourth quarter GNP statistics, at first blush, seem to suggest. While business fixed investment in real terms did decline at a 7% annual rate, that drop was due entirely to a slump in expenditures on transportation equipment—items that have little impact on the nation's over-all productive capacity. Excluding autos, trucks, and aircraft, real outlays for more basic fixed capital were up at an 8½% annual rate last quarter—hardly an indication of any widespread weakness.

The latest government survey of business investment intentions (conducted by the Commerce Department near the end of 1979) indicates that businesses plan to increase expenditures this year on plant and equipment by about 11% in current dollars or 1% to 2% after adjustment for inflation.* While such a gain would be a significant deceleration from the 1979 pace, a rise in real capital outlays of this magnitude still would represent a relatively large increase in investment expenditures for a year of recession or stagnation. But capital spending surveys do miss the mark on occasion—especially at turning points in the cycle. Could it happen once again?

Mistakes in guessing the trend of sales appear to be the most important factor affecting how accurate capital spending surveys turn out to be. To illustrate: at the end of 1974, retail sales dropped sharply following a very strong run-up—a striking example of a deterioration in sales that businesses did not foresee. Capital budget decisions, meanwhile, apparently were being made in expectation of sustained growth in sales. The result: survey responses which produced the largest error in the history of the Commerce survey of spending intentions.

This did not imply, however, the complete absence of business caution. Indeed, the ordering rate in the nondefense capital goods area—a good barometer of near-term equipment-spending trends—had been pared back notably by the end of 1974. Nonetheless, the signals

*Significantly, there is growing evidence that surveys increasingly have been understating actual capital outlays. As a consequence, strength in business fixed investment, as eventually measured in the GNP accounts, could turn out to be even stronger than that implied by the Commerce survey.

which they had hit in response to the shock of October 6, they, too, generally moved upward, partly in response to anticipated Federal Reserve moves toward further monetary tightening.

Although the unsettled conditions in markets during the latter part of January invited comparisons to the situation prior to the Fed's dramatic policy moves of October 6, the similarity between the two situations is rather spurious. The run-up in metals' prices in recent weeks is at least as much a reflection of world-wide military and political uncertainties as it is a symptom of worsening expectations with regard to U.S. inflation. Furthermore, while the dollar has been back in the neighborhood of its pre-October 6 lows relative to the German mark for a number of weeks, it has shown near-term stability despite the rush into gold.

What the Fed does now seems more likely to depend rather narrowly on the behavior of money and credit. The evidence in this regard is mixed. The monetary aggregates have all decelerated sharply in the period since October 6. For example, the "narrow" money supply, or M_1, which consists of currency in the hands of the public and checking accounts at commercial banks, had been growing at a 10% annual rate in the third quarter of 1979. In the fourth quarter, its average growth rate was just over 3%. While that is good news, a similar

emanating from consumer markets at the end of that year were not yet clear enough to facilitate a more perceptive reading from survey respondents of actual investment needs.

Lesson for 1980

What then is the lesson for capital spending in 1980? First, there was some reduction in the ordering rate over the course of last year, but it was not nearly so severe as that which occurred in the prior cycle. With the help of a yearend surge, new orders for nondefense capital goods in December stood only 5% below their peak of last March. Second, the surprising resilience of consumer demand in the final months of last year—in sharp contrast to the rapid deterioration at the end of 1974—doesn't point to a sharp deviation between actual and expected sales. This, in turn, suggests, most importantly, that capital spending may well track survey intentions closely in the months ahead. And with the impetus from stepped-up defense procurement likely to be felt increasingly in the second half of the year, current investment intentions actually could be upgraded as the year unfolds.

pattern of deceleration in 1978, which was reversed in the spring of 1979, raises the question of whether the recent slowdown will be similarly short-lived. Furthermore, although commercial and industrial loans outstanding at large banks actually fell in November, the pace of lending accelerated substantially in December.

A similarly mixed impression emerges from an examination of those policy instruments over which the Fed has direct control, such as the discount rate. After the dramatic increase in the discount rate to 12% in October, the Fed has maintained that level—despite broad hints that frequent adjustments in the discount rate might very well be part of the System's new operating procedures.

According to the Fed, under these new procedures, the day-to-day conduct of monetary policy now focuses on providing the banking system with the amount of reserves needed to keep the monetary aggregates within their target ranges. It was anticipated in October that this approach would result in substantially more short-run variability in the Federal funds rate than had been permitted previously, when the Fed acted so as to keep that rate within a narrow band. Although the funds rate did swing widely in the weeks immediately after October 6, its variability in recent weeks has been much less. Since the start of December, the weekly average level of the funds rate has stayed within the 13½%-14% range. Presumably, this relative stability is reflective of the fact that the Fed's monetary growth targets are being met. A test of that inference will come only when and if monetary growth rates change.

The possibility that monetary growth could accelerate is suggested by the fact that some measures of bank reserves have been expanding quite rapidly (e.g., nonborrowed reserves and the "monetary base," the latter consisting of currency in the hands of the public and total reserves adjusted for changes in reserve requirements). The growth of total reserves, however, has decelerated markedly since mid December, as a large decline in borrowings from the Fed has tended to offset increases in nonborrowed reserves. If bank loans were to maintain their recent high growth rates and the monetary aggregates to accelerate once again, the pressure would clearly be back on the Fed to reassert its willingness to limit reserve availability even at the cost of a new run-up in interest rates.

While there is no reason to doubt the Fed's resolve to stand by its October 6 policy and to

take the necessary steps to slow the growth of money and credit, such actions by themselves are not sufficient, of course, to constitute an effective anti-inflation program. Given the projected increases in defense expenditures, fiscal policy will likely be moving in an expansionary direction over the coming year. Until the Fed gets support from fiscal and other governmental policies (including actions to stimulate saving and investment), the impact of monetary actions on the course of inflation is not likely to be decisive.

Arms and the Budget

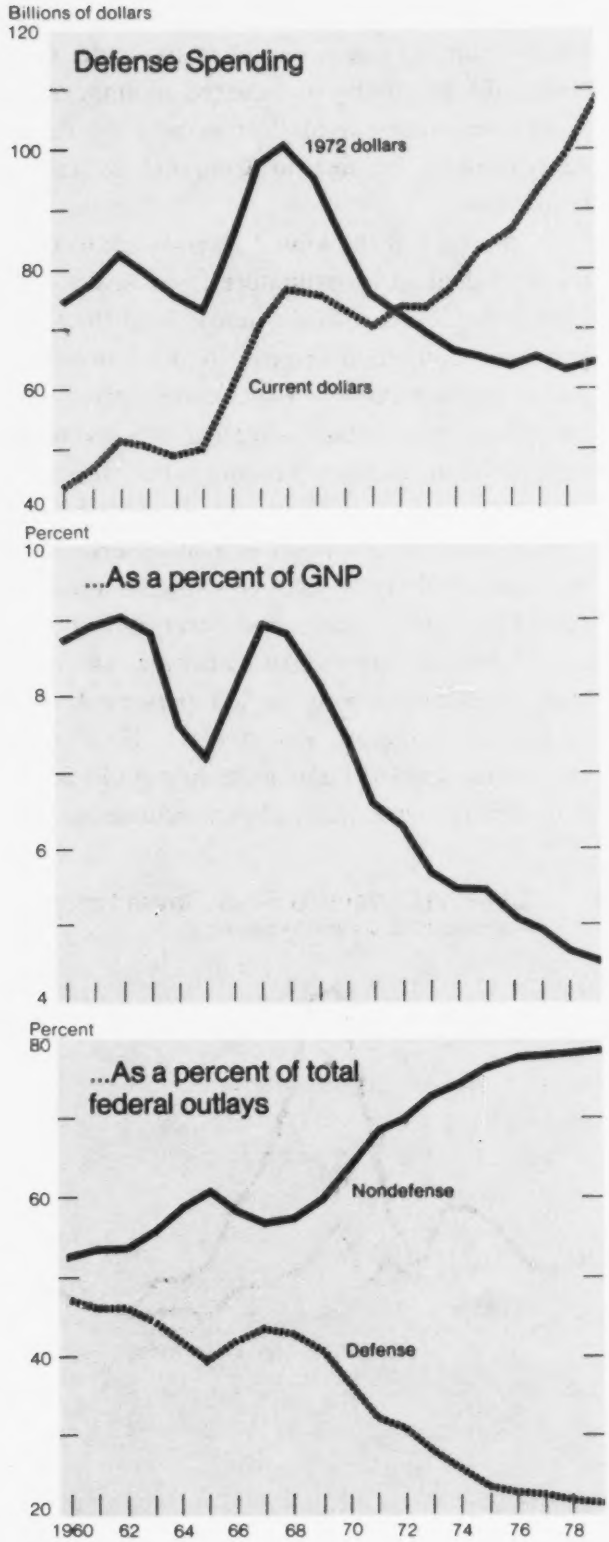
PRESIDENT Carter's new budget marks a shift in national priorities: more for defense; less scope for expansion of all other programs. In the year beginning October 1, the President is asking for budget authority for defense of $158.2 billion, an increase of about 5½% in real terms over the level proposed for the current fiscal year. Even more significant, the President is proposing a substantial rise in the military budget far into the future: through 1985, budget authority is projected to rise at a rate of about 5% in real terms; outlays, at about a 4% rate. Clearly, the object now is to exceed by a wide margin the 3% annual growth target agreed to at NATO summit meetings in 1977—the basis for earlier five-year plans.

A big expansion of the defense effort will spread through the economy—from major defense contractors to thousands of subcontractors and suppliers. The rapidity and magnitude of the stepped-up effort are uncertain, however. That's partly because the Administration has presented a broad proposal rather than a detailed blueprint. Moreover, Congress may well enlarge upon the President's program in response to the Soviet invasion of Afghanistan —something that occurred after most of the key budget decisions had already been made.

The direction of arms spending, in any case, seems set—even if world tensions ease in coming months. The shock of events in Iran and Afghanistan has produced a national sense of frustration and anger at U.S. impotence to bring power to bear in a critical part of the world. Suddenly, the public has come to realize the degree to which U.S. military strength has waned relative to that of the Soviet Union. That decline has become especially crucial because of the Soviet threat in the Middle East and Persian Gulf areas—the oil lifeline of the industrialized West. Hitherto not central to the concerns of U.S. defense—traditionally preoccupied with Western Europe and the Far East —that part of the world has taken on a strategic importance that apparently is well understood by the American public. The nation thus seems to have emerged from the climate of the late 1960s and 1970s, when the legacy of disenchantment over Vietnam crimped the military effort (chart on page 7).

Defense comparisons

Soviet military spending has nearly doubled in real terms since 1963, whereas real outlays by the U.S. have declined substantially. Soviet defense expenditures came to equal those of the



U.S. by about 1971, but now exceed U.S. arms spending by a growing margin (chart on page 8). In terms of manpower, Soviet forces have increased steadily from about 3½ million in the mid 1960s to roughly 4½ million at present. U.S. forces, in contrast, after rising to about 3½ million at the peak of the Vietnam War, declined sharply during the early 1970s and now number just over 2 million—some 600,000 below pre-Vietnam levels.

Looking back on the longer-run trend in the defense budget, it is clear that the reduction in U.S. defense outlays that occurred after Vietnam amounted to more than a dismantling of the additional effort created to fight the war. Noteworthy also is the massive reduction in real terms in nonpayroll expenditures that occurred beginning in the late 1960s (chart on page 9).

Adjusted for inflation, outlays for military hardware, spare parts, research and development, and other nonpayroll items in the budget were cut almost in half between fiscal years 1968 and 1976. Not only was there strong public objection to growth in the defense budget in the aggregate, but such growth as occurred was largely preempted by manpower costs. Despite cutbacks in troop strength, payroll costs jumped sharply—increasing 50% during those years, even though growth of the total defense budget was limited to 14%. As a consequence, by 1976 such costs came to absorb about 57% of defense outlays, as compared with about 43% in 1968. Comparability statutes, tying federal pay to private-sector standards, caused a sharp increase in average salaries for both military personnel and Pentagon civilians. Moreover, retirement costs almost quadrupled, reflecting growing numbers of retirees, higher salary levels, and the especially favorable cost-of-living escalators in effect at that time. And, in the early 1970s, the

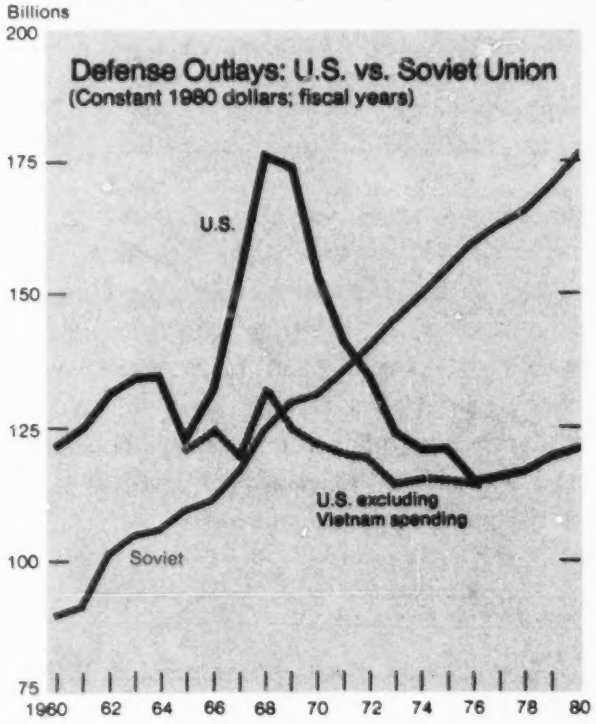
nation moved to an all-volunteer force. A one-time increase of some 55% in the base pay of enlistees was seen as needed to attract and hold recruits under the new system.

In the past several years, however, with transition to a volunteer force completed, the growth of manpower outlays has been moderated. Importantly, pay "caps" were imposed on all federal employees for general budgetary reasons. And other steps were taken to curb manpower costs—including controls on grade "creep" and less favorable cost-of-living increases for retirees. As a consequence, as the chart on page 9 indicates, growth in defense spending was able to accommodate weapons programs, research and development, and other defense-related outlays to a much greater extent than was the case early in the 1970s.

The plan submitted to Congress last month indicates that such outlays are slated to rise at an accelerated pace over the course of the next five years. In fact, should manpower levels remain relatively constant—as is now projected—the nonpayroll purchases of the Pentagon stand to rise some 40% in real terms between the current fiscal year and 1985. That increase, indeed, would rival the growth of such outlays during the Vietnam War period.

It is not at all clear that force levels in fact will remain relatively constant—at appreciably below pre-Vietnam manning levels—given the commitment to defense of U.S. interests in the Middle East and Persian Gulf areas that is now being formulated. The U.S. has never had a substantial, permanent on-the-ground presence in that area of the world, relying instead on local defense efforts. Now, however, the U.S. has stated its intention to use force if necessary to protect its interests in the region. Whether the so-called rapid deployment force can be relied on for this purpose or whether a substantial troop presence will be necessary is apparently among decisions yet to be made. Certainly, the possibility of enlarged military manpower has been raised dramatically by President Carter's request to Congress to revive registration.

In any case, if the armed services are to continue to depend on volunteers, pay scales will have to be adjusted to the demands of the marketplace. Continued erosion in the purchasing power of the incomes of servicemen cannot go on indefinitely without creating serious manning problems in many military jobs—especially during the early 1980s as the dwindling birth rates of the 1960s are felt in a sharp decline in the number of young men reaching 18 years of age. For some years now, recruitment has lagged behind targets. And attrition has been high, especially among skilled personnel such as pilots, engineers, and doctors. Even with substantial upward adjustment in payroll costs, however, it seems likely that procurement, re-



U.S.-SOVIET MIGHT: AN OFFICIAL ASSESSMENT

THE changed picture of U.S. military capability vis-à-vis the Soviet Union is revealed in comments by two leading authorities.

From Defense Secretary Harold Brown, in a recent statement to the Senate Armed Services Committee:

"Not only has the military balance between us deteriorated, but the Soviets have now built a war machine far beyond any reasonable requirements for their own defense and security . . .

"The problem is the result of more than a decade of steady, resolute, and comprehensive growth [in defense spending] on the part of the Soviet Union that we simply have not matched. Just as the effects of this disparity have taken years to accumulate, so they will take years to eliminate."

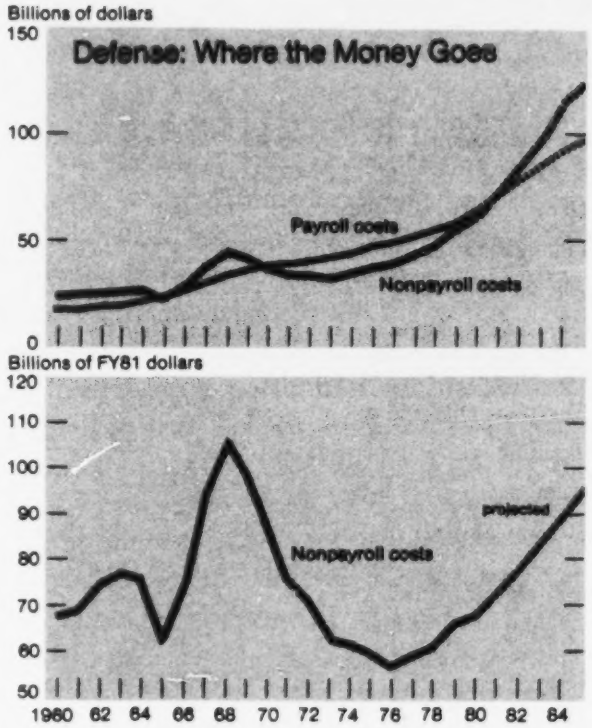
From General David C. Jones, Chairman of the Joint Chiefs of Staff, in the annual military posture statement:

"The Soviets have for years continued to out-man, out-gun, out-build, and out-deploy us in most meaningful military categories, all the while shortening our qualitative lead in many important areas."

search, and other nonpayroll demands by the Pentagon will rise at a rate appreciably above what was assumed just a short time ago. This is, of course, the message broadcast in recent weeks by the rise that has occurred in the prices of defense-related stocks. Sales of military equipment to other countries, symbolized by new U.S. aid to Pakistan, presumably will also be rising sharply in years to come.

Assessing the impact

How rapidly proposed increases in budget authority for defense will be translated into



actual outlays is difficult to foresee. Today's highly complex weapons systems involve long lead times, and thus the direct economic impact of budget decisions being made now won't loom especially large during the coming year. The chances that the U.S. economy will move into a severe recession in the coming year, nevertheless, seem to have been reduced –since staffing plans and inventory decisions by contractors in anticipation of stepped-up orders presumably will be affected quickly.

There is little doubt that over the long haul a defense plan as ambitious as the one presented by President Carter will have a major impact on the U.S. economy. Enlarged defense commitments represent yet another claim on resources in an economy that has suffered recurring capacity-constraint problems for many years. There is always the risk–one not faced during the Vietnam War build-up–that the nation's resources will be stretched thin, with

Major Missions and Programs

(Budget authority, billions of dollars)

	1979	*1980**	*1981**	*1982**	*1983**
Strategic forces	8.0	10.3	11.7	13.3	14.9
General purpose forces	47.4	51.6	58.3	66.1	74.1
Intelligence and communications	8.0	9.1	10.6	12.0	13.5
Airlift and sealift	1.7	2.0	2.4	2.7	3.1
Guard and reserve	6.9	7.6	8.7	9.9	11.1
Research and development	10.9	11.8	14.1	16.0	17.9
Central supply and maintenance	13.0	14.5	15.6	17.7	19.8
Training, medical, general personnel activities	26.4	28.7	32.9	37.3	41.7
Administration	2.3	2.5	3.0	3.3	3.6
Support of other nations	0.4	0.6	0.9	1.1	1.3
Total	125.0	138.6	158.2	179.4	201.0

*Estimate

adverse consequences for the long-run inflationary trend.

Substantial enlargement of the defense budget could add materially to the federal deficit and to federal borrowing needs in coming years. Such an outcome would not occur, of course, if there were to be at the same time a reassessment of the nation's ability to continue to add to nondefense spending at the rate of recent years.

Accommodation of increased defense spending could also occur if the American public were prepared to accept a growing tax burden. The public's support for an increased defense effort is visible—reflected in polls and in the enthusiastic Congressional response to the President's proposals. However, willingness to pay for it—in the form of taxation or in reduced expectations of what other government programs can provide—is yet to be demonstrated.

The Saving Rate: How Serious the Decline?

HAVE once-thrifty Americans become a nation of spendthrifts? Some analysts are beginning to wonder about that as they observe the steady drop in the Commerce Department's estimate of the personal saving rate to its lowest point in nearly three decades. At 3.3 cents for each dollar of after-tax income in the fourth quarter of 1979, the saving rate was less than half its average in the first half of the Seventies and well below the average of six cents of each dollar of income in the years since World War II.

This pattern of decline in the saving rate—assuming the statistics are correct—is, of course, of considerable economic significance. The fact, for instance, that households spent a larger share of income in 1979 helped stave off the onset of recession. And a continuation of that trend could help sustain economic activity this year. The ultimate price, however, of better-sustained economic activity in the short run could well be high.

One possibility is that retrenchment in the household sector, when it comes, will be far more pronounced than it otherwise would have been. And, even if sharp retrenchment were somehow avoided, there would still be reason for concern over the implications for the longer-term health of the economy of a permanently lower propensity to save by households. Historically, the household sector has been a major contributor to the pool of national savings available to accommodate capital formation. Given the critical need to accelerate capital formation, in the interest of improving productivity gains, the declining trend of household saving is most unwelcome.

The possibility does have to be recognized that the Commerce Department's estimate of saving is incorrect. Commerce statisticians do not make a direct tally of funds put aside by households, but rather arrive at an estimate of personal saving by an indirect method. Household after-tax or disposable income is estimated from income data, and household outlays are estimated from consumption data. Household saving is then derived as the difference between the two. A relatively small error in estimating either income or outlays can make a big difference in the saving rate (saving as a percent of disposable income). And frequently in the past Commerce's national income and product accounts (NIPA) have been revised substantially on both the income and expenditure sides.

An alternative estimate of household saving is derived by the Federal Reserve Board as part of its flow-of-funds tabulations. This second measure—arrived at by a somewhat different estimating technique—provides a useful check on the accuracy of Commerce's data. The Federal Reserve attempts to measure saving directly by estimating all net increases in household-sector assets (including both financial assets such as money, savings accounts, stocks and bonds, and tangible assets such as homes, noncorporate business plant and equipment, automobiles, and other consumer durables) and subtracting from the total all estimated net increases in household-sector liabilities. The difference is the change in household net worth or, equivalently, saving.

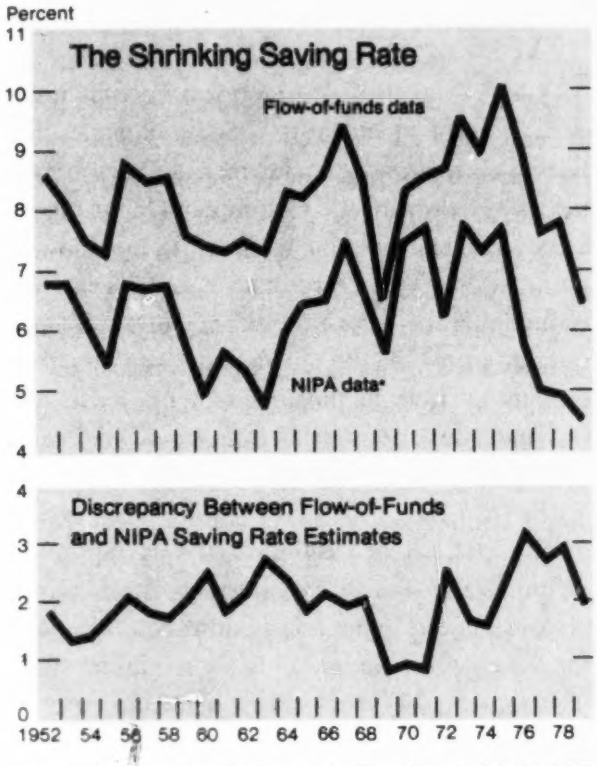
In principle, the flow-of-funds saving total for the household sector should equal saving as derived from the national income and product accounts after adjustment for some conceptual differences, mainly the treatment of purchases of consumer durables as consumption expenditures rather than saving in the national ac-

counts. Divided by the household sector's disposable income, the adjusted flow-of-funds saving total should produce a saving rate identical to the Commerce Department's. That, however, is not the case; as the chart on this page shows, the saving rate derived from the flow-of-funds accounts is consistently greater than the saving rate estimated by Commerce from the national income and product accounts.

The discrepancy between the two measures of saving suggests that year after year an estimating error of the same nature characterizes some portion of the work of either Fed or Commerce statisticians. The Federal Reserve measure would, of course, be biased upward if statisticians had greater success in identifying and counting assets than in identifying and counting liabilities. But there seems no reason to presume that should be so. Indeed, the reverse might logically be expected, since from the standpoint of minimizing taxes people have more incentives to "hide" assets than to hide liabilities.

What seems more likely is that Commerce's estimate of saving is biased downward because of the powerful inducements that exist in an environment of high-rate taxation for people to hide or underreport income. In recent years, there has been growing appreciation that in fact an important "subterranean economy" exists in which a large number of people are paid for their services in cash "off the books."

Even so, the fact that a discrepancy exists between the Federal Reserve's measure of saving and Commerce's measure seems less significant than the fact that the two measures show remarkably similar movements over time. What seems most important is the evidence both measures provide that there has been a slide toward a decidedly lower household-sector saving rate in the recent past. In


Percent
The Shrinking Saving Rate
Flow-of-funds data
NIPA data*
Discrepancy Between Flow-of-Funds and NIPA Saving Rate Estimates
1952 54 56 58 60 62 64 66 68 70 72 74 76 78

*National income and product accounts. Flow-of-funds data for 1979 are averages of the first three quarters.

short, the saving slump is for real. If that's accepted, the crucial questions become: What caused the slump, and is it likely to persist?

The fact that the slide in the saving rate of the past few years has coincided with a sharp worsening of inflation suggests that the two developments are related—specifically that acceleration in the rate of general price increase has caused people to save less. If that is indeed the case, it represents a significant departure from the typical response pattern in the U.S. throughout most of the postwar period.

Prior to the 1970s, a quickening of inflation typically was associated with a rise in the saving rate, apparently reflective of two influences: first, a perceived need on the part of savers to earmark enlarged amounts of dollars for specific purposes (e.g., college tuition or a

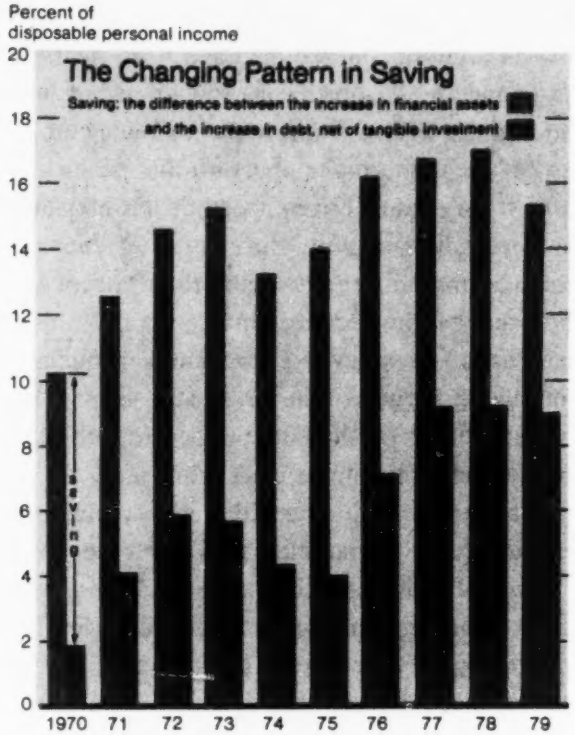
trip to Europe); second, a perceived need for larger defensive reserves in an environment of inflation-induced uncertainty. For the time being at least, that earlier well-defined response pattern—more inflation, more saving—has either vanished or has been overwhelmed by other influences. Now the response seems to be: the more inflation, the less saving.

Precisely why such a change has occurred is not certain, but a number of plausible explanations can be advanced. Some families, first of all, presumably have not been willing to lower their general living standards abruptly when confronted with markedly higher prices for such necessities as energy and food. For such families, the maintenance of living standards has left a smaller portion of income available for saving than formerly. And some families have undoubtedly elected to save less simply because the long persistence of serious inflation has caused them to lose confidence that government will get inflation rates down. Anticipating continuing high-level inflation, they simply have succumbed to a "buy-now-before-it-costs-more" attitude, thereby lessening the proportion of income saved.

A third—and undoubtedly powerful—factor working to lessen saving propensities in recent years has been the phenomenal escalation that has occurred in home prices. This has given the home-owning part of the populace a feeling of growing affluence, with the result that many families perceive a lessened need to save.

More debt, less saving

As noted earlier, saving (i.e., an increase in net worth) must take the form of an increase in assets or a reduction in liabilities. In the chart on this page, the increase in assets includes only the increase in financial assets. Investment in



Data for 1979 are averages of the first three quarters.

tangible assets (for example, homes and autos) is deducted from the increase in debt. Saving is represented by the difference between the increase in financial assets and the increase in debt net of tangible assets.

As the chart shows, the decline in the saving rate during the 1970s was reflected mainly in an increase in the rate of debt accumulation by households. Indeed, until last year, net additions to financial assets, as a share of income, had continued to increase throughout most of the decade.

The biggest contributor to the increase in household-sector indebtedness has been the growth of mortgage debt. Americans have taken generous advantage of the enlarged borrowing capacity they have come to enjoy as a result of the build-up of home-ownership equity. Indeed, consistently in recent years the rise in

household indebtedness has run far in excess of the amount that would have been necessary to finance growth of the nation's housing stock, and much of the "surplus" borrowing apparently has gone to support consumption.*

To the extent, of course, that the household sector itself has been the source of mortgage finance, the household saving rate has not been affected by the increase in mortgage debt because increases have occurred in both assets and liabilities within the household sector. However, a rising portion of the increase in household-mortgage finance during recent years appears to have originated, directly or indirectly, outside the household sector—for example, through the intermediary role of U.S. government-sponsored agencies which raise funds in nationwide money and capital markets and funnel these into the thrifts and other mortgage-buying institutions. Such outside financing of household-sector mortgage indebtedness has been a factor in the decline of the household-sector saving rate.

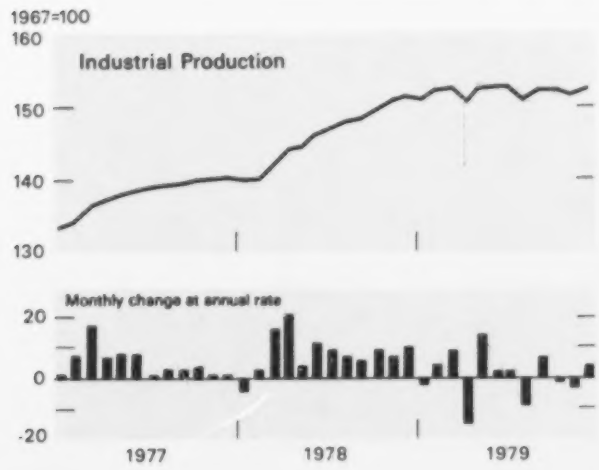
In longer-run perspective, the decline in the household sector's share of the contribution to the nation's pool of savings is worrisome because of the need for increased saving to finance more capital investment by business. That potential problem did not in fact manifest itself last year; indeed, investment in plant and equipment as a share of GNP was near record levels. What made that possible, in terms of the national pattern of saving and investment, was significant saving outside the household sector: an over-all governmental budget surplus (with state and local surpluses more than exceeding the federal deficit) and funds pouring into the U.S. from OPEC and other foreign investors. In view, however, of the prospect that the federal government deficit has now entered a new phase of enlargement (in part because of the trend toward bigger military outlays) and in view also of the national objective of limiting oil imports, it may be progressively less easy for the business sector to find financing for its investment programs.

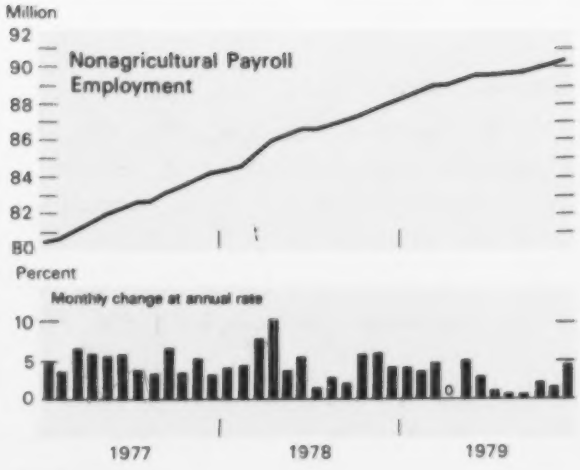
*See "Tapping the Home Equity Till," *The Morgan Guaranty Survey*, August 1979.

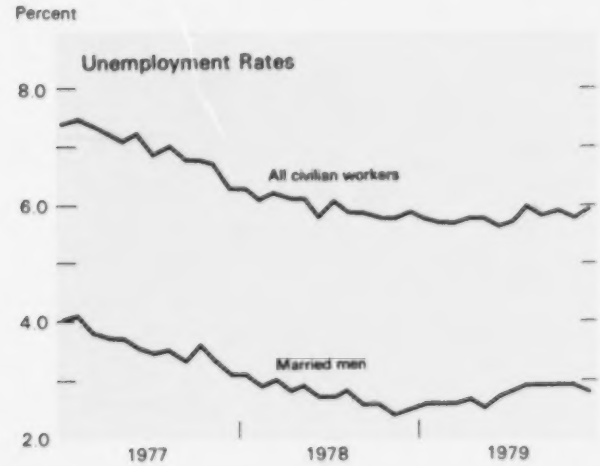
Lending curtailment ahead?

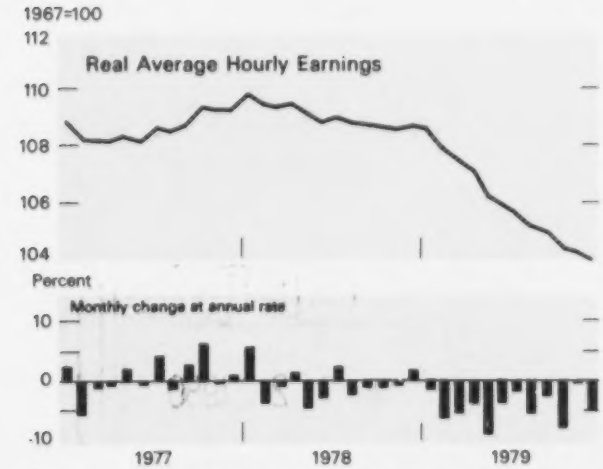
Judgments about what's likely to happen to the personal saving rate in 1980 and beyond can be drawn only tentatively. The rate of personal saving was low and was still falling at 1979's end according to virtually every indicator. In the short run, the constraint on further reductions in the household-sector saving rate will probably be the unwillingness of lenders to assume the credit risk, especially now that real estate prices are showing evidence of topping out. In this regard, it may be worth noting that the decline in the saving rate in 1979 was not simply a continuation of past trends. As shown in the chart on page 13, the decline in the household saving rate in 1979, in contrast with most other recent years, was the result of a drop in the rate of financial asset accumulation rather than an increase in the rate of additions to debt. Net increases of household sector indebtedness (relative to income) stopped rising in the case of mortgage credit and actually declined in the case of consumer credit. It appears that consumers, constrained perhaps in adding further to their debt, have begun to divert funds away from financial asset accumulation as a means of maintaining previous levels of consumption. That may be signaling the end of the household-sector's ability to continue to lower its saving rate.

ECONOMIC INDICATORS









NOTE: Latest plotting in each chart is for the month of December. All data are seasonally adjusted. Average hourly earnings are adjusted for overtime hours in manufacturing and for interindustry employment shifts.

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